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EXECUTIVE COMPENSATION LIMITS REDUX

What the Economic Stimulus Plan Has Changed for Bank Executives and Others

by Ellen R. Marshall and Craig D. Miller

On February 4, 2009, the U.S. Treasury Department announced new guidelines on executive compensation restrictions for financial institutions that receive TARP funding. (See our Newsletter dated February 6, 2009 for a description of those guidelines.) Nine days later, Congress has adopted rules on the same subject, as part of the much larger American Recovery and Reinvestment Act of 2009 (ARRA). (Click here to see the Executive Compensation Provisions of the new statute.)

That the ARRA (often referred to as the economic stimulus plan) would contain provisions on this subject at all has surprised many observers. By themselves, these new rules are not particularly stimulative of the economy, which has been a litmus test for various other proposals that Congress considered for inclusion in the statute. Clearly, though, many members of Congress have been fuming about what they perceive as excesses in the area of bank compensation, and they felt it important to include provisions in their legislation, rather than relying on the new Administration, through its Treasury Department, to tighten the standards.

The executive compensation provisions in ARRA have many similarities with those of the Treasury guidelines. The areas of difference, however, are striking and quite sweeping. Their full import will not be known until the Treasury Department issues regulations interpreting and applying them. Since, however, the statute becomes law immediately when the President signs it, banks cannot wait until those details are issued. Rather, banks need to alter their executive compensation practices now if they are to be in compliance with the new

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Coverage of Prior TARP Recipients

The new provisions will apply to financial institutions that are in receipt of funding under the "TARP" provisions of the Emergency Economic Stabilization Act of 2008 (EESA), including those that received that funding before passage of ARRA. Accordingly, all companies that previously participated in the Treasury's capital purchase program and sold preferred stock to the Treasury will be covered by many of these new limitations. By contrast, the Treasury guidelines were limited to recipients of TARP funds in the future.

Coverage of All TARP Recipients

The new provisions will apply to financial institutions that receive any sort of TARP funding. By contrast, most of the constraints that were in the Treasury guidelines applied only to those financial institutions that receive "exceptional" negotiated funding. Only a small, and less burdensome, set of restrictions would have applied to financial institutions receiving funding under a program that was generally available to qualifying applicants.

Cap on Incentive Compensation

The new provisions have the effect of eliminating the payment or accrual of bonus, retention, and incentive compensation of any kind (including *all* cash bonuses), other than restricted stock awards (which themselves are subject to significant limitations), except for payments made pursuant to a written employment contract executed on or before February 11, 2009, as determined by the Treasury. This provision would apply so long as any obligation arising from financial assistance under TARP remains outstanding. Evidently, Congress considered there to be a gaping hole in the Treasury Department's guidelines when it came to noncash compensation, particularly long-term awards of restricted stock. The Treasury Department would have permitted such awards, as long as the cash benefits could not be realized until after the TARP funds had all been repaid. Congress, however, has now capped even the amount of these deferred-vesting stock awards.

There will now be a limit on the use of restricted stock compensation, equal to stock having a value of one-third (1/3) of the employee's annual compensation. It is unclear how annual compensation will be determined for purposes of this limitation.

The method for determining the "value" of restricted stock for this purpose, as well as other terms and conditions for implementing this restriction, is to be established by regulations of the Treasury Department. Conceivably, the value determination process may offer opportunities for the design of equity-based incentive programs that have substantial upside potential, even within the valuation restriction. It is hard to imagine, though, that such opportunities would result in compensation packages that approach those historically used for the top executives at many financial companies.

The limit on restricted stock compensation applies to a different group of employees than the other restrictions. The number of employees (who may or may not be executives) covered depends on the amount of money received under TARP, as follows:

If the amount of TARP funds received is . . .	The limit on restricted stock compensation applies to . . .
Less than $25 million	The single most highly compensated employee
$25 million to $249.9 million	The 5 most highly compensated employees*
$250 million to $499.9 million	The "senior executive officers" [as defined in EESA, this is essentially the top 5] plus the next 10 most highly compensated employees*
$500 million or more	The "senior executive officers" [as defined in EESA, this is essentially the top 5] plus the next 20 most highly compensated employees*

* In the case of recipients of $25 million or more, the group of covered employees may be expanded further by the Treasury Department.

There is an exception from this restriction for bonus payments under a written employment contract executed before February 11, 2009. The interpretation of this exception will be critical for companies that have not yet paid out bonuses for services performed in 2008. For example, if a company that received TARP funding has a cash incentive bonus plan, will payments under that plan for work completed in 2008 be prohibited in their entirety? The language in the statute requires Treasury Department interpretive guidance.

Furthermore, ARRA permits the Treasury Department to review bonuses, retention awards, and other compensation paid to senior executive officers and the next 20 most highly compensated employees of companies that previously received TARP assistance before the enactment of ARRA, to determine whether any such payments were inconsistent with the purposes of ARRA. This suggests a possibility that companies and relevant employees might be required to disgorge incentive and cash bonuses paid or accrued after the company received TARP funds, but before ARRA was enacted.

Elimination of "Golden Parachute" Payments

ARRA also prohibits any TARP recipient from making any golden parachute payment to a senior executive officer or any of the next five most highly compensated employees during the time any obligation arising from federal government assistance remains outstanding. ARRA defines a "golden parachute" payment as any payment to a senior executive officer for departure from a company for *any* reason, except for payments for services performed or benefits accrued. Unlike regulations promulgated pursuant to EESA that defined a "golden parachute" payment as a payment in connection with involuntary termination in an amount which exceeds three times (3x) the average annual compensation a covered employee received over the last five years (subject to proposed amendment to decrease such payment to one times (1x) average annual compensation), ARRA's golden parachute definition appears to allow a covered employee to recover only his or her accrued salary. Arguably, such a restriction would also encompass any change-in-control payments made to a covered employee who leaves in the context of an acquisition. Further guidance from the Treasury will be needed in order to determine the full scope of this significant restriction on TARP recipients.

Board Compensation Committee

Each TARP recipient must have a Board Compensation Committee, comprised entirely of independent directors. Its meetings and reports are prescribed by ARRA. Most public companies will already have a structure that is, or can easily be adapted to be, adequate for this purpose.

Nonpublic companies that receive less than $25 million in TARP funds will be permitted to have the whole Board function in this capacity. Larger nonpublic companies, however, may not now have any committee of this sort, and may need to add independent directors in order to populate the requisite committee.

Shareholder Votes

The shareholders of each TARP recipient are to be given the opportunity to vote on executive compensation, though the results of that vote are to be nonbinding. This concept was also present in the Treasury guidelines previously released. Clearly, both the Obama Administration's Treasury Department and Congress wish to see the types of disclosure that would be included in a proxy statement inviting a vote by shareholders. Clearly, too, they do not wish to relieve the Board of Directors from responsibility for making compensation decisions. Exactly how these nonbinding votes will be conducted, when companies will be required to submit such votes, and what the shareholder resolutions will say are likely to present an interesting challenge to corporate lawyers as we move through the next proxy season.

Opportunity to Return TARP Funds

A casual observer might question whether Congress has the right to change the rules for those financial institutions that already received TARP funds. In doing so, Congress has in part relied upon the fact that each TARP agreement contains (as required by the Treasury Department) a contractual right on the part of the government to change the rules. We may all have observed the leading banks in this country being pressured by former Treasury Secretary Paulson into accepting money that they (largely) protested they did not need, in order to legitimize the TARP program in the first place. But those companies did also sign on to agreements that stated the terms of the deal could be modified unilaterally by the government in the future. Those contractual clauses now form the basis for the imposition of these new compensation rules.

In view of the retroactive application, however, Congress has included in ARRA an opportunity for prior recipients of TARP funds to repay the funds and walk away with the consent of their primary regulator, rather than limit their executive compensation in the manner that will now be imposed. How this walk-away provision will be promulgated will be interesting, since the charter amendments that all participants in the capital purchase program adopted prohibit any sort of redemption of the preferred stock issued to the Treasury Department within the first three years absent a concurrent offering of qualifying equity capital, including common or preferred stock.

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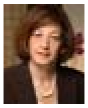

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