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Stimulus Act's New Restrictions on Executive Compensation

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act (known widely as the stimulus act) intended to stimulate the U.S. economy in the midst of the global financial crisis. The stimulus act contains large-scale amendments to the executive pay restrictions originally set forth under the Troubled Asset Relief Program (TARP).

Unlike prospective guidelines that had been issued by Treasury on February 4, 2009, these new restrictions are applicable to the approximately 360 companies that had already entered into a program under TARP, as well as companies that receive new funds from Treasury. Many believe that the new law's executive compensation provisions will serve as an incentive for companies currently under TARP to exit out of the program by returning funds to Treasury.

Introduction

The Troubled Asset Relief Program (TARP) was implemented on October 3, 2008 under the Emergency Economic Stabilization Act of 2008 (EESA) for the purpose of providing $700 billion of governmental aid to financial institutions. A number of executive compensation restrictions were required for financial institutions that entered into a TARP agreement with Treasury. (See our October 20, 2008 *For Your Information*.)

Thus far, approximately 360 "healthy" financial institutions have entered into TARP's Capital Purchase Program (CPP). A handful of institutions have entered into TARP's other programs designed for companies in greater need of assistance (namely AIG, Citigroup, Bank of America, Chrysler, General Motors, and GMAC).

In addition, on February 4, 2009, Treasury proposed a new set of guidelines and restrictions on executive compensation at financial institutions receiving TARP assistance. These guidelines came at the heels of general public outrage over substantial Wall Street bonuses and the perceived misuse of federal bailout funds received by financial institutions. The restrictions enhanced and tightened those originally put forward under TARP in October 2008 and distinguished between companies receiving a general level of federal aid from those needing exceptional assistance. Although these guidelines were proposed, they were never officially passed and implemented.

Stimulus Law's New Limits on Executive Pay

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (ARRA), which amended TARP and dictated new limits on executive compensation. The law's executive compensation restrictions generally far exceed the restrictions set forth under the original TARP provisions as well as Treasury guidance issued on February 4, 2009. While Treasury's restrictions were generally applicable to prospective TARP participants, the rules under ARRA apply to financial institutions that *have already entered into a program under TARP*. In addition, while previous guidelines distinguished between companies receiving a standard or general level of federal aid from those receiving an exceptional level, the new limits in ARRA simply apply to *all TARP recipient companies* (however, bonus prohibitions do vary depending upon the amount of TARP funding received).

We outline the key provisions of ARRA below.

Golden Parachutes

Broader Definition of "Golden Parachute." Prior TARP rules prohibited golden parachutes to senior executive officers (SEOs – generally the top 5 executives reported in the proxy) upon *involuntary* separation of employment. The original restrictions still generally permitted payments of up to a 3X "base amount" factor. ARRA prohibits golden parachutes to SEOs upon departure *for any reason* (except for payments for "services performed" or "benefits accrued") during the period in which the company is still under TARP assistance and eliminates the ability to pay amounts up to the 3X base amount threshold. Further, the corporate governance standards (below) broaden the application of the prohibition to include the next 5 most highly-compensated employees (in addition to the SEOs).

> ***BUCK COMMENT.*** *Under ARRA's definition of "parachute payment," the elimination of the base amount threshold literally solely applies to SEOs – thus it is not clear if the next 5 most highly-compensated employees are prohibited from receiving any payments or if they are permitted up to a threshold amount.*

Corporate Governance Standards

Continuation of "Unnecessary and Excessive" Risk Provisions. ARRA continues to require limits on compensation that exclude incentives for SEOs to take "unnecessary and excessive risks" that threaten the value of the TARP recipient.

> ***BUCK COMMENT.*** *Basically, under prior rules, the compensation committee of an affected institution was only responsible for reviewing incentive arrangements of SEOs and certifying that it has completed its required reviews. Prior to ARRA, Treasury had issued guidelines requiring an explanation of how the compensation arrangements do not encourage excessive and unnecessary risk taking.*

Basically, compensation committees will be required to better understand the full spectrum of risk (good and bad) inherent within an organization. Since the compensation committee's certification is required to be included with the company's next proxy filing, it is essential for committee members to quickly address this need to allow for sufficient time to develop a solid understanding of the company's risk factors, review and assess incentive arrangements covering senior executives, and address any gaps that would result in noncompliance.

As a first step in the assessment process, it would be prudent for compensation committees, working with the senior risk officer and, most likely, the audit committee, to gain a solid understanding of each of the significant risks that the company faces. The determination of how incentive plans affect such risks and further assessing if such risks are "unnecessary and excessive" is perhaps the biggest challenge companies under TARP face with respect to executive compensation.

Continuation of $500,000 Annual Deduction Limit. ARRA retains the annual tax deduction limit of $500,000 of compensation paid to a SEO, as originally set forth under TARP (with no exception for performance-based compensation or stock options).

Expansion of Clawbacks. ARRA allows for the recovery of any bonus, retention award, or incentive compensation paid to any one of the 5 SEOs and any of the next 20 most highly-compensated employees based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.

Expansion of Golden Parachute Prohibition. As mentioned above, ARRA contains a prohibition on any golden parachute payment to a SEO or any of the next 5 most highly-compensated employees.

Prohibition on Bonuses. Although there is no cap on annual cash compensation (unlike Treasury's guidelines which had basically provided a $500,000 annual cap), ARRA contains a prohibition on paying or accruing *any bonus, retention award, or incentive compensation*. However, this prohibition shall not apply to the payment of long-term restricted stock, provided that such stock –

- does not fully vest during the period in which the company is still under TARP assistance
- has a value that is not greater than 1/3 of the total amount of annual compensation of the employee receiving the stock
- is subject to such other terms and conditions as Treasury may determine is in the public interest.

The employees to which the prohibitions described above apply are determined by the level of TARP funding received by financial institutions as follows –

- If the funding is equal to or less than $25,000,000, the prohibition shall apply only to the most highly-compensated employee.

- If the funding is equal to at least $25,000,000, but less than $250,000,000, the prohibition shall apply to at least the 5 most highly-compensated employees or such higher number as Treasury may determine is in the public interest.
- If the funding is equal to at least $250,000,000, but less than $500,000,000, the prohibition shall apply to the 5 SEOs and at least the 10 next most highly-compensated employees, or such higher number as Treasury may determine.
- If the funding is equal to $500,000,000 or more, the prohibition shall apply to the 5 SEOs and at least the 20 next most highly-compensated employees, or such higher number as Treasury may determine.

The prohibitions described above shall not apply to any bonus payment required to be paid pursuant to a written employment contract executed on or before February 11, 2009, as such valid employment contracts are determined by Treasury.

BUCK COMMENT. *The provisions described above raise a whole host of issues and questions. Much guidance is needed in the determination of SEO status (with respect to the individuals other than the principal executive officer (PEO) and principal financial officer (PFO)) as well as individuals that fall into the "most highly-compensated employee" group. Given the inability to pay bonuses other than a limited amount of restricted stock, it will be easy for employees to drop out of a status that they normally would fall into. Further, it is not clear as to what is to be used as "compensation" for making this determination – e.g., would it include accruals under deferred compensation arrangements and SERPs?*

In addition, some companies are questioning whether their financial statements have to be restated as a result of any potential retroactive impact from ARRA's requirements.

Finally, since there is no specified limit on annual base salary, it would not be surprising to see companies attempt to rationalize higher levels of base pay to compensate for the lost ability to provide incentive awards. Until there is further guidance, TARP companies may decide to refrain from making any bonus payments or incentive grants to any individual who may fall into a prohibited category. This would include bonuses for 2008 (which typically are paid out on or before March 15 for calendar year companies) unless it was determined that such payment is required to be paid pursuant to a written employment contract executed on or before February 11, 2009.

No Manipulation Rule. ARRA prohibits any compensation plan that would encourage manipulation of the reported earnings to enhance the compensation of any of its employees.

Certification Requirement. The CEO and CFO shall provide a written certification of compliance with the above requirements (a) in the case of a public company to the SEC, together with annual filings required under the securities laws, and (b) in the case of a TARP recipient that is not a publicly-traded company, to Treasury.

> ***BUCK COMMENT.*** *Once again, additional guidance is required as it is not clear how these requirements will be administered. The SEC's Division of Corporation Finance issued on February 24 interpretations indicating that this requirement will not be effective until Treasury releases further guidance.*

Board Compensation Committee

Board Establishment Requirement. Each TARP recipient shall establish a Board Compensation Committee, comprised entirely of independent directors, for the purpose of reviewing employee compensation plans.

Frequency of Meetings. The Committee must meet at least semiannually to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to the company from such plans.

> ***BUCK COMMENT.*** *Basically, under prior rules, the compensation committee of an affected institution was only responsible for reviewing incentive arrangements of SEOs on an annual basis. It appears that this requirement has not only added to the frequency of the review but has broadened the scope to arrangements that cover employees beyond the SEO group.*

Luxury Expenditures

Prohibition of Excessive Expenditures. Similar to the guidelines proposed by Treasury, this provision requires the board of directors of the company to adopt a company-wide policy regarding excessive or luxury expenditures (as identified by Treasury) which may include –

- entertainment or events
- office and facility renovations
- aviation or other transportation services
- 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 the business operations.

> ***BUCK COMMENT.*** *This requirement is largely a result of general public outrage over the well-publicized level of perquisites provided to troubled financial institution and auto industry executives despite poor corporate performance, cash-flow concerns, and wide-scale layoffs. This issue has become a "hot button" for corporations in general and pressure to pull back on these types of expenditures will likely grow.*

Shareholder "Say-on-Pay" Resolution

Annual Shareholder Approval of Executive Compensation. This provision requires an annual nonbinding shareholder "say-on-pay" vote to approve executive compensation of the SEOs, as required to be disclosed pursuant to SEC compensation disclosure rules (which must include the compensation discussion and analysis, the compensation tables, and any related material).

BUCK COMMENT. *The SEC's February 24 interpretations clarified that proxy-reporting TARP companies must allow for a "say-on-pay" vote with their upcoming proxy filings which, for most companies, is only several weeks away (barring a postponement of such filing). The interpretations further indicate that a company that plans on meeting this requirement by including its own proposal to have shareholders approve executive compensation will be required to file a preliminary proxy statement pursuant to Exchange Act Rule 14a-6(a).*

Review of Prior Payments to Executives (Potential Retroactive Clawbacks)

In General. Treasury shall review bonuses, retention awards, and other compensation paid to the SEOs and the next 20 most highly-compensated employees of any entity that received TARP funds before the enactment of ARRA to determine whether any such payments were inconsistent with the purposes of TARP or were otherwise contrary to the public interest.

Negotiation for Reimbursement. If Treasury determines that a payment was made as described above, it shall seek to negotiate with the TARP recipient and the subject employee for appropriate reimbursements.

BUCK COMMENT. *These provisions are also largely a result of general public outrage over the well-publicized bonus payments to Wall Street executives for 2008 despite the economic collapse. While $18.4 billion of bonus payments were reported, many believe that such figure is grossly understated.*

A new bill was introduced on February 19, the Economic Adjustment Recovery Act of 2009 (S. 431), under which an Office of Taxpayer Advocate would be established to assist Treasury in its duty to negotiate a reimbursement of prior payments. Under the bill, it appears that the intent is to seek reimbursement in cases where "unreasonable compensation" was paid to executives when, in the absence of TARP funding, the organization would have become insolvent and such compensation would have been reduced as part of a bankruptcy restructuring or liquidation. Under the bill, the term ''executive compensation'' means wages, salary, deferred compensation, benefits, retirement arrangements, options, bonuses, office fixtures, goods or other property, travel or entertainment, vacation expenses, and any other form of compensation, obligation, or expense that is not routinely provided to all other employees of the assisted entity.

Conclusion

While there are many details that will need to be ironed out, these new restrictions will significantly impact executive compensation for companies under TARP. Critics argue that the limitations weaken executives' incentives to deliver the long-term performance that is needed to bring recovery to financial firms and the economy as a whole, thus undermining the very purpose of TARP. Whether intended by lawmakers or not, as a result of the restrictions, it would seem that "healthy" financial institutions will think long and hard about remaining in TARP, and financial institutions that have not yet entered into TARP but were planning to do so will want to reconsider.

Longer Term View – Need for Risk Management

The application of the underlying principles of the executive compensation provisions could ultimately apply to a broader "main street" population of public companies. Prior to ARRA, Treasury had indicated the need to begin a serious effort to examine how company-wide compensation strategies at financial institutions – not just those related to top executives – may have encouraged excessive risk taking that contributed to current market events and to begin developing model compensation policies for the future. Treasury suggested the following steps –

- establish a requirement for compensation committees of all public financial institutions – not just those receiving government assistance – to review and disclose executive and certain employee compensation arrangements and explain how these compensation arrangements are consistent with promoting sound risk management and long-term value creation for their companies and their shareholders
- require top executives at financial institutions to hold stock for several years after it is awarded/vested as this encourages a more long-term focus on the economic interests of the firm
- establish a requirement for firms to offer shareholders a non-binding resolution on both the levels of executive compensation and how the structure of compensation incentives help promote risk management and long-term value creation for the firm and the economy as a whole.

As shareholders seek greater accountability of corporate executives and corporate boards, compensation committees will need to develop "best practices" associated with a company's executive pay programs.