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New Executive Compensation Restrictions for TARP Recipients

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The American Recovery and Reinvestment Act of 2009, signed by the President on February 17, 2009, makes some significant changes to the executive compensation restrictions under the Emergency Economic Stabilization Act of 2008 ("EESA"). For financial institutions that are considering participating in the Troubled Assets Relief Program ("TARP"), there are new or revised restrictions as well as review and certification requirements that need to be considered.

Executive Compensation Restrictions

The executive compensation restrictions are generally as follows:

- Any bonus, retention award or incentive compensation paid to a senior executive officer ("SEO") who is one of the top five (5) most highly paid executives of a public company whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and non-public company counterparts, plus any of the next 20 most highly compensated employees must be subject to recovery (i.e., a "clawback" provision) if such payments are later found to be based on materially inaccurate statements of earnings, revenues, gains or other criteria. *(Note: The prior version of the EESA applied the requirement only to the SEOs and did not include retention awards.)*
- There is a prohibition on making any golden parachute payment, which applies to a payment for the departure from a company for any reason except for payments for services performed or benefits accrued, to an SEO or any of the next five (5) most highly compensated employees during the period in which any obligation arising from the financial assistance remains outstanding (the "TARP Period"). *(Note: The prior version of the EESA only applied the prohibition to the SEOs.)*
- There also is a prohibition on paying or accruing any bonus, retention award or incentive compensation during the TARP Period, except for the payment of certain long-term restricted stock if such restricted stock meets the following criteria: it does not fully vest during the TARP Period; it has a value that is not greater than one-third (1/3) of the total amount of the employee's annual compensation; and it is subject to other terms and conditions required by the Secretary of the Treasury (the "Secretary"). This requirement applies to the most highly compensated employee if the financial assistance is less than \$25,000,000; the number of employees affected increases thereafter based on the size of the TARP assistance. *(Note: This requirement was not included in the prior version of the EESA.)*
- There is a further general prohibition on maintaining any compensation plan that would encourage manipulation of the reported earnings of the TARP recipient, and a general limitation on compensation that excludes incentives for SEOs to take unnecessary and excessive risks that threaten the value of the recipient during the TARP Period.
- Deductions for compensation (including incentive compensation and deferred compensation) under Internal Revenue Code Section 162(m)(5) are limited to \$500,000 per year for covered executives, which includes the chief executive officer, the chief financial officer and the next three highest compensated officers, for any year in which the government continues to have an interest in the TARP recipient. *(Note: None of the otherwise applicable exemptions under Code Section 162(m), such as the exemption for performance-based compensation, would appear to apply under Code Section 162(m)(5)).*

Executive Compensation Restrictions for TARP Recipients (continued)

Review and Certifications

The review and certification requirements are as follows:

- The Chief Executive Officer and Chief Financial Officer (or equivalents thereof) must certify in writing that the institution has complied with the executive compensation guidelines.
- A TARP recipient must establish a Board Compensation Committee, comprised entirely of independent directors, for the purpose of reviewing all employee compensation plans. For privately-held institutions receiving less than \$25,000,000, the duties of the committee are carried out by the Board of Directors. *(Note: The requirement does not appear to be limited to executive compensation plans.)*
- The Board must have a company-wide policy regarding excessive or luxury expenditures on (i) entertainment and events, (ii) office and facility renovations, (iii) aviation and transportation, and (iv) other activities and events that are not reasonable expenditures conducted in the normal course of business.
- Any proxy consent or authorization for an annual or other meeting of the shareholders must permit a separate shareholder ("say on pay") vote to approve the compensation of executives. However, such vote is nonbinding on the Board and will not be construed as overruling the decisions of the Board. The Securities and Exchange Commission is required to issue regulations on these requirements by February 16, 2010. *(Note: It is not clear whether the new requirements must be incorporated into proxy statements.)*

Financial institutions will need to determine how these requirements apply to the various agreements they have in place such as employment agreements, option agreements and supplemental executive compensation agreements.

If you have any questions regarding the new compensation requirements under the EESA for TARP recipients, please contact B. David Joffe or Charles M. ("Chip") Cain II in the Employee Benefits & Executive Compensation Group. Or, if you have other, general questions regarding TARP and the Treasury's Capital Purchase Program, please contact Dave Drescher, John Titus, Paul Ware or Paul Compton in the Banking & Financial Services Group.

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