

The American Recovery and Reinvestment Act of 2009:
Executive Compensation and Corporate Governance Provisions

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the “Act”) authorizing increased governmental spending and tax relief in an effort to preserve and create jobs and promote economic recovery. The Act also amends Section 111 of the Emergency Economic Stabilization Act of 2008 (12 U.S.C. 5221) (the “EESA”) and thereby strengthens and increases requirements related to executive compensation and corporate governance for entities which receive financial assistance under the troubled assets relief program (the “TARP”). Below is a summary of the executive compensation and corporate governance provisions contained in the Act.¹ As noted below, many of the details of how the Act is actually to be applied are broadly stated and, therefore, regulations and other guidance from the Secretary of the Treasury (the “Secretary”) will be needed in order to understand more precisely how the Act is to be given practical effect.

Applicability

The Act specifies that the executive compensation and corporate governance provisions contained therein, as well as the provisions of section 162(m)(5) of the Internal Revenue Code of 1986 (which imposes a \$500,000 cap on deductibility for compensation paid to covered executives²), are applicable to any “TARP recipient” during the period in which any obligation of such TARP recipient arising from financial assistance provided under the TARP remains outstanding. The term “TARP recipient” is defined as “any entity that has received or will receive financial assistance under the financial assistance provided under the TARP.” The Act specifies that if the Federal Government merely holds warrants to purchase common stock of a TARP recipient, this does not constitute an outstanding obligation. The Act also specifies that the executive compensation restrictions contained in Section 111 of EESA are not applicable to entities solely participating in a loan modification.

The Act provides that the Secretary is required to promulgate regulations to implement the standards summarized below and also grants the Secretary the authority to adopt additional standards. It is not clear whether these standards are effective immediately or will become effective once the Secretary has issued its regulations.

¹ The Act is contained in Public Law 111-5 which contains two major divisions: Division A (Appropriations Provisions) and Division B (Tax, Unemployment, Health, State Fiscal Relief, and Other Provisions). Only the provisions of Title VII (Limits on Executive Compensation) of Division B are summarized in this memorandum.

² Section 162(m)(5)(D) of the Internal Revenue Code of 1986, as amended, generally defines “covered executive” as any employee who either (i) is the chief executive officer or the chief financial officer, or an individual acting in either such capacity, or (ii) is one of the three highest compensated officers (other than the chief executive officer or chief financial officer).

Executive Compensation

Prohibition on Compensation Incentives for Unnecessary and Excessive Risks

The Act prohibits TARP recipients from having any compensation plan that contains incentives for their senior executive officers (as defined below) to take unnecessary and excessive risks that threaten the value of such recipients during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding.

Recovery of Incentive Compensation Paid Pursuant to Materially Inaccurate Criteria

TARP recipients must institute provisions for the recovery of any bonus, retention award, or incentive compensation paid by them to a senior executive officer and any of their next 20 most highly-compensated employees based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.

Prohibition on Golden Parachute Payments

The Act prohibits TARP recipients from making any golden parachute payment to a senior executive officer or any of the recipient's next five most highly-compensated employees during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding.

Definition of "Senior Executive Officer"

The term "senior executive officer" is defined as an individual who is one of the top five most highly paid executives of a public company, whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934, and any regulations issued thereunder, and non-public company counterparts.³

Definition of "Golden Parachute Payment"

"Golden parachute payment" is broadly defined 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."⁴

Prohibition on Paying or Accruing Incentive Compensation

Pursuant to the Act, TARP recipients are prohibited from paying or accruing any bonus, retention award, or incentive compensation during the period in which any obligation arising from financial assistance provided

³ The Act does not set forth a measurement date for identification of senior executive officers or other highly compensated employees. The Act also does not address situations where an employee is identified as a senior executive officer or a highly compensated employee in one year but fails to qualify as such in a later year as a result of the application of the standards set forth in the Act.

⁴ It is unclear whether this definition includes deferred compensation or other accrued but unvested benefits that vest upon termination of employment.

under the TARP remains outstanding. This prohibition does not apply to the payment of long-term restricted stock by a TARP recipient, so long as such long-term restricted stock:

- does not fully vest during the period in which any obligation arising from financial assistance provided to such TARP recipient remains outstanding;
- has a value in an amount that is not greater than 1/3 of the total amount of annual compensation⁵ of the employee receiving the stock; and
- is subject to such other terms and conditions as the Secretary may determine is in the public interest.

However, the Act does not prohibit 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 the Secretary or the designee of the Secretary.

The Act delineates the scope of the prohibition on payment or accrual of any bonus, retention award, or incentive compensation based upon the amount of financial assistance received by the financial institution under the TARP in the following manner:

- Less than \$25,000,000 received, the prohibition applies to only the most highly-compensated employee of the financial institution.
- \$25,000,000 to less than \$250,000,000 received, the prohibition applies to at least the five most highly-compensated employees of the financial institution, or such higher number as the Secretary may determine is in the public interest with respect to any TARP recipient.
- \$250,000,000 to less than \$500,000,000 received, the prohibition applies to the senior executive officers and at least the 10 next most highly-compensated employees, or such higher number as the Secretary may determine is in the public interest with respect to any TARP recipient.
- \$500,000,000 or more received, the prohibition applies to the senior executive officers and at least the 20 next most highly-compensated employees, or such higher number as the Secretary may determine is in the public interest with respect to any TARP recipient.

Prohibition on Compensation Plans Encouraging Manipulation of Earnings

The Act prohibits TARP recipients from having any compensation plan that would encourage manipulation of their reported earnings to enhance the compensation of any of their employees.

⁵ The Act does not define “total of annual compensation.” It is unclear whether wages reported on an employee’s W2, total compensation under the SEC’s proxy disclosure rules, or some other measure should be utilized.

Review of Prior Payments to Executives

The Act requires the Secretary to review bonuses, retention awards, and other compensation paid to the senior executive officers and the next 20 most highly-compensated employees of each entity receiving TARP assistance before the date of enactment of the Act, to determine whether any such payments were inconsistent with the purposes of Section 111 of EESA or the TARP or were otherwise contrary to the public interest.

In the event the Secretary finds such inconsistency, the Secretary is required to seek to negotiate with the TARP recipient and the subject employee for appropriate reimbursements to the Federal Government with respect to compensation or bonuses.

Corporate Governance

Certificate of Compliance

As amended by the Act, Section 111 of EESA now requires the chief executive officer and chief financial officer (or the equivalents thereof) of each TARP recipient to provide a written certification of compliance by the TARP recipient with the requirements of Section 111 in the following manner⁶:

- in the case of TARP recipients whose securities are publicly traded, to the Securities and Exchange Commission, together with annual filings required under the securities laws; and
- in the case of TARP recipients that are not publicly traded companies, to the Secretary (presumably on an annual basis although this is not specified by the Act).

Board Compensation Committee

The Act requires each TARP recipient to establish a Board Compensation Committee, comprised entirely of independent directors, for the purpose of reviewing employee compensation plans. Each TARP recipient's Board Compensation Committee is required to meet at least semiannually to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to such TARP recipient from such plans.

Compliance by Non-SEC Registrants

The Act requires that the duties of a Board Compensation Committee must be carried out by a TARP recipient's board of directors if (i) the common or preferred stock of such TARP recipient is not registered pursuant to the Securities Exchange Act of 1934 and (ii) such TARP recipient has received \$25,000,000 or less of TARP assistance.

⁶ By a letter sent to the Chairman of the Securities and Exchange Commission and dated February 20, 2009, the Chairman of the Senate Committee on Banking, Housing and Urban Affairs, Senator Christopher Dodd, shared his view that this certification requirement is not effective until the Secretary establishes the related executive compensation and corporate governance standards.

Limitation on Luxury Expenditures

Pursuant to the Act, the board of directors of any TARP recipient must have in place a company-wide policy regarding excessive or luxury expenditures as identified by the Secretary, including excessive expenditures on the following:

- entertainment or events;
- office and facility renovations;
- aviation or other transportation services; or
- 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 of the TARP recipient.

Non-Binding Shareholder Approval of Executive Compensation (“Say on Pay”)

The Act requires that any proxy or consent or authorization for an annual or other meeting of the shareholders of any TARP recipient during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding must permit a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to the compensation disclosure rules of the Securities and Exchange Commission (which disclosure must include the compensation discussion and analysis, the compensation tables, and any related material). On February 24, 2009, the Securities and Exchange Commission issued Compliance and Disclosure Interpretations (the “CDI”) related to the “Say on Pay” provisions of the Act.⁷ According to the CDI, the separate shareholder vote requirement is only applicable to the annual meeting of shareholders for which proxies will be solicited for the election of directors or a special meeting in lieu of such annual meeting. The CDI does not specify an effective date for application of the separate shareholder vote requirement; however, the CDI does note that Senator Dodd, by his letter sent to the Securities and Exchange Commission and dated February 20, 2009, stated his view that this provision of the law became effective on February 17, 2009. Therefore, the Senator noted that the separate shareholder vote requirement would not apply to preliminary (and related definitive proxy statements filed after February 17, 2009) or definitive proxy statements filed with the Securities and Exchange Commission on or before February 17, 2009, but would apply to proxies filed after that date.

The CDI also specifies that smaller reporting companies subject to the Act’s “Say on Pay” provisions but not required to provide compensation discussion and analysis under Item 402 of Regulation S-K will not be required to provide compensation discussion and analysis disclosure.

In the event a company determines to comply with the Act’s “Say on Pay” provisions by including its own proposal to have shareholders approve executive compensation, such company will be required to file a

⁷ Available at <http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm>

preliminary proxy statement pursuant to Exchange Act Rule 14a-6(a). According to the CDI, if such a company faces special circumstances and would like to request acceleration of Rule 14a-6(a)'s ten-day review period then it should contact the Assistant Director of the office that reviews the company's filings to discuss the special circumstances the company faces and how the ten-day review period could be accelerated.

The separate shareholder votes required by the Act will not be binding on the board of directors of a TARP recipient, and may not be construed as overruling a decision by such board, nor to create or imply any additional fiduciary duty by such board, nor may such votes be construed to restrict or limit the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.

By February 17, 2010, the Securities and Exchange Commission must issue any final rules and regulations required by the "Say on Pay" provisions contained in the Act.

No Impediment to Withdrawal by TARP Recipients

Subject to consultation with the appropriate Federal banking agency (as that term is defined in section 3 of the Federal Deposit Insurance Act), if any, the Secretary must permit a TARP recipient to repay any assistance previously provided under the TARP to such financial institution, without regard to whether such financial institution has replaced such funds from any other source or to any waiting period, and when such assistance is repaid, the Secretary must liquidate warrants associated with such assistance at the current market price.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; John Schuster at 212.701.3323 or jschuster@cahill.com; Glenn Waldrip at 212.701.3110 or gwaldrip@cahill.com; Mike Wenzel at 212.701.3527 or mwenzel@cahill.com; or Andrew Blau at 212.701.3316 or ablau@cahill.com.

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80 Pine Street | NY, NY | 10005-1702 | Phone: 212.701.3000 | Fax: 212.269. 5420 | Cahill.com

CAHILL GORDON & REINDEL LLP