

DAVIS POLK & WARDWELL

Compensation Provisions in the American Recovery and Reinvestment Act of 2009

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Today, the President is expected to sign into law the American Recovery and Reinvestment Act of 2009, commonly referred to as the stimulus bill. This new legislation contains provisions relating to compensation paid by institutions that receive government assistance under TARP, including institutions that have already received such assistance. These provisions include restrictions on the amounts and forms of compensation payable, provision for possible reimbursement of previously paid compensation and a requirement that compensation be submitted to non-binding “say on pay” shareholder votes.

Overview

The Emergency Economic Stabilization Act of 2008, enacted on October 3, 2008, authorizes the U.S. Department of Treasury to access up to \$700 billion to protect the U.S. economy and restore confidence and stability to the financial markets. To date, funds have been allocated to institutions under Treasury’s Capital Purchase Program¹ and, in exceptional circumstances, through individually negotiated agreements with the federal government. This financial stability legislation authorizes Treasury to impose executive compensation restrictions on participating institutions, in accordance with standards specified in the statute. Institutions participating in the Capital Purchase Program have agreed to standardized restrictions adopted by Treasury, whereas institutions entering into additional arrangements with Treasury have agreed to more onerous, individually negotiated restrictions.

On February 4, 2009, Treasury announced new guidance² for executive compensation paid by financial institutions that receive government assistance in the future. The guidance outlines provisions relating to limitations of compensation and golden parachute payments, the clawback of previously paid compensation, the submission of compensation to non-binding “say on pay”

¹ A comprehensive review of the Capital Purchase Program executive compensation rules can be found in our client memorandum “[Executive Compensation Rules Under the Emergency Economic Stabilization Act of 2008](#)” dated October 23, 2008.

² A comprehensive review of this guidance can be found in our client memorandum “[New Executive Compensation Restrictions Under the Emergency Economic Stabilization Act of 2008](#)” dated February 6, 2009.

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Application

- » **Applies to all TARP participants, including those previously receiving assistance**
- » **Authorizes Treasury to seek reimbursement of previous compensation deemed inappropriate**
- » **Does not apply if government only holds warrants or institution only participates in loan modification program**
- » **Institution may avoid compensation provisions by repaying assistance**
- » **Key provisions may apply not only to executive officers but also to highly compensated *employees***

shareholder votes, the certification that compensation does not encourage excessive risk taking and the adoption of a policy on “luxury” expenditures. A number of these elements had appeared in some form in the Capital Purchase Program and subsequent one-off arrangements agreed to by those seeking TARP assistance.

In expanding on the financial stability legislation’s original executive compensation provisions, the stimulus bill incorporates many of the provisions covered by the February 4 guidance, but also imposes additional restrictions. Notably, the stimulus bill includes a new prohibition on paying bonuses, retention awards and incentive compensation. There are inconsistencies between the stimulus bill and the guidance that will need to be harmonized if the stimulus bill does not supersede the guidance in its entirety. Some of these inconsistencies are noted below.

The stimulus bill expressly requires the Secretary of Treasury to promulgate regulations to implement the compensation requirements included in the bill. No deadline for the promulgation of these regulations is specified, and one question is whether these compensation requirements apply prior to the implementation of regulations. The stimulus bill also authorizes the Secretary to impose other standards, presumably on a general or case-by-case basis. In addition, as noted below, the SEC is required to issue final regulations regarding “say on pay” within one year. Ideally, the Treasury and SEC regulations will be subject to public notice and comment; however, the financial stability legislation permits Treasury to issue rules interpreting its provisions without this process.

Application

Application to All TARP Participants. The stimulus bill’s compensation provisions apply to any institution that has received or will receive financial assistance under TARP. This contrasts with the February 4 guidance, which applies only prospectively to institutions that accept new assistance.

The stimulus bill authorizes the Secretary to review bonuses, retention awards and other compensation paid to “senior executive officers” (defined as described below) and the next 20 most highly compensated employees of each institution that received assistance before the date of its enactment to determine whether any such compensation was inconsistent with the purposes of the compensation restrictions under the stimulus bill or TARP or was otherwise

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contrary to the public interest. If the Secretary determines that such compensation was so inconsistent, the stimulus bill requires the Secretary to seek to negotiate with the institution and the employee who received the compensation for appropriate reimbursement to the federal government.

Limits on Application. The stimulus bill's compensation provisions do not apply during any period in which the federal government only holds warrants to purchase common stock of an institution, nor do they apply to an institution that is only participating in a loan modification program.

Withdrawal. The stimulus bill provides that, subject to consultation with any appropriate federal banking agency (the Federal Reserve, for any bank holding company), the Secretary will permit an institution to repay any assistance previously provided under TARP to such institution, without regard to whether the institution has replaced such funds from any other source or to any waiting period. When such assistance is repaid, the Secretary will liquidate warrants associated with such assistance at the current market price. Therefore, institutions may avoid becoming or remaining subject to the stimulus bill's compensation provisions by repaying the assistance that they previously received and foregoing future assistance.

Executives versus Employees. The stimulus bill imposes limitations on both "senior executive officers" and, in some key provisions, on a specified number of employees, based apparently on the amount of their compensation, without any reference to the executive or managerial responsibilities of such employees. The definition of "senior executive officers" in the stimulus bill is the same as that originally appearing in the financial stability legislation, as well as in certain of the individually negotiated agreements. Senior executive officers have been consistently defined as "the top 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 any regulations issued thereunder, and non-public company counterparts".

Treasury's interim rules announced on January 16, 2009 regarding the Capital Purchase Program clarify the definition of senior executive officer by linking it to the concept of "named executive officers" in the SEC's compensation disclosure rules, as implied by the reference in the statute. Thus, "senior executive officers" means "named executive officers", defined as the institution's chief executive officer, chief financial officer and next three most highly compensated executive officers, as determined in accordance with the

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Limits on Incentive Compensation

- » Prohibits any “bonus, retention award or incentive compensation” to certain individuals
- » Exception for long-term restricted stock, if stock does not fully vest during assistance period, and if value of stock does not exceed one-third of annual compensation
- » Number of individuals impacted by compensation limitations depends on amount of assistance received

requirements of the SEC’s compensation disclosure rules. Presumably, this definition is the controlling definition of senior executive officers under the stimulus bill as well.

It follows that references in the stimulus bill to “the senior executive officers and the *next* [x] most highly-compensated employees” are intended to convey continuity between the two groups. As such, it would be logical for the stimulus bill’s provisions to apply only to an institution’s executive officers or other senior executives with policy or managerial responsibilities. If the provisions are intended to apply to an institution’s employees, regardless of whether they have any executive or managerial responsibilities, this would contrast not only with the financial stability legislation and the February 4 guidance, but also the scope of the compensation restrictions applicable in the context of previously negotiated exceptional assistance, where the provisions have been limited to an institution’s executive officers and other individuals with positions of leadership and accountability.

Limits on Incentive Compensation

Prohibition. Subject to the exception for long-term restricted stock described below, the stimulus bill prohibits an institution from paying or accruing any “bonus, retention award or incentive compensation” with respect to at least the following employees, depending on the amount of assistance received by the institution:

- » \$500 million or more of assistance – the five senior executive officers and the next 20 most highly compensated employees.
- » \$250 million to less than \$500 million of assistance – the five senior executive officers and the next 10 most highly compensated employees.
- » \$25 million to less than \$250 million of assistance – the five most highly compensated employees.
- » Less than \$25 million of assistance – the most highly compensated employee.

The prohibition on paying or accruing any bonus, retention award or incentive compensation may apply to additional employees with respect to an institution receiving \$25 million or more in assistance, if the Secretary determines that it is

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in the public interest with respect to the institution. The prohibition does not apply to any bonus required to be paid under a written employment agreement executed on or before February 11, 2009, if the Secretary determines such agreement to be valid.

The prohibition raises a number of interpretive questions, such as:

- » How is the amount of compensation measured for purposes of determining the employees covered by the prohibition? Is it the prior year's compensation? Is it compensation for the year prior to the first receipt of assistance? Is compensation to be computed in accordance with the SEC's rules for disclosing compensation, the IRS's requirements for income recognition or another methodology altogether?
- » Is it likely that the group of executives or employees covered will change from year to year? That is, might individuals whose compensation is limited in one year due to the stimulus bill's provisions exit the group the next year, with new individuals taking their place? How are new hires to be treated?
- » What definition of compensation will most closely align a ranking of executives based on compensation with a ranking based on managerial responsibility and accountability, particularly in light of recent voluntary and mandatory reductions in compensation, including those imposed by the stimulus bill?
- » What forms of compensation constitute a "bonus, retention award or incentive compensation"? Are long-term and performance-based awards excluded in this context, as they are not in the nature of the kind of compensation sought to be restricted? What about stock options or other equity awards (other than restricted stock, for which there is a specified exception)?
- » What does it mean to "accrue" a bonus, retention award or incentive compensation? One reading is that an "accrued" item is one where payment has become due. This would be consistent with the SEC's interpretation of an "accrued" amount of compensation. Other readings could include an amount where there is a meaningful likelihood of payment or where there is no substantial risk of forfeiture,

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consistent with the presumptive meaning of “accrued” in the stimulus bill’s golden parachute provisions described below. This would harmonize with the approach of the February 4 guidance by requiring repayment of TARP assistance, or other progress toward the other goals of the financial stability legislation or the stimulus bill, before the compensation accrued and became payable. In this context, Treasury regulations could presumably provide relief under Internal Revenue Code Section 409A to facilitate payments tied to the kinds of performance conditions, such as repayment of assistance and redemption of government-owned securities, sought to be encouraged.

Exception for Long-Term Restricted Stock. The stimulus bill permits an institution to make payments in restricted stock to the subject employees; provided that the stock may not fully vest during the period that assistance remains outstanding, and the amount of the stock’s value may not exceed one-third of the total amount of the employee’s annual compensation. The stimulus bill authorizes the Secretary to impose such other terms and conditions on the restricted stock as the Secretary may determine are in the public interest.

This exception, like the prohibition on incentive compensation generally, raises interpretive questions:

- » Does “long-term restricted stock” mean only time-vested restricted stock?
- » Does the requirement that the stock not “fully” vest during the period that assistance remains outstanding permit the stock to partially vest? If so, are there limits on the portion that may vest or the rate at which it may vest?
- » When is “payment” of the stock deemed to occur? At grant? At settlement (*i.e.*, when the stock fully vests following repayment of the assistance)?
- » How or when is the restricted stock valued for purposes of the one-third limitation? In the year of grant? Year of payment? Year by year? In the aggregate? Is the restricted stock itself included in the “total” amount of annual compensation?

Interaction with Guidance. The stimulus bill does not make clear whether or how the bill’s limits on incentive compensation are intended to supplement, if

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"Say on Pay"

- » Shareholders are entitled to annual non-binding "say on pay" vote on executive compensation each year during assistance period

at all, limits on annual compensation in the February 4 guidance. The guidance would prohibit a covered institution (which does not include TARP participants prior to February 4 who do not seek additional assistance) from paying annual compensation in excess of \$500,000 to its senior executives (apparently, limited to its five senior executive officers), with an exception for compensation granted in the form of restricted stock or a similar long-term incentive. Superimposing the new stimulus bill requirements on top of those in the guidance, an institution covered by both regimes would be permitted to pay each of its five senior executive officers annually only \$500,000 in cash plus an amount in restricted stock having a value equal to one-third of the executive's annual compensation.

"Say on Pay"

Requirement for "Say on Pay" Vote. The stimulus bill provides that an institution's shareholders must be provided with an annual non-binding "say on pay" vote on executive compensation each year during the period in which the institution is receiving assistance.

Effectiveness of Requirement. The SEC is required to issue final regulations regarding "say on pay" within one year after the date of enactment of the stimulus bill. The stimulus bill does not clarify whether the requirement is intended to apply immediately to institutions that previously received assistance, or whether the requirement will only become effective after the SEC issues its regulations. This provision may be similar to several provisions in the Sarbanes-Oxley Act of 2002, including those involving corporate responsibility and enhanced financial disclosures, which did not become effective until the SEC promulgated rules or regulations. Because this provision affects the SEC's existing regulations regarding proxies and proxy disclosure, the SEC presumably will amend the proxy disclosure rules to make "say on pay" a proxy statement requirement.

Interaction with Guidance. Under the February 4 guidance, an institution receiving new exceptional financial recovery assistance is required to submit its compensation to a non-binding "say on pay" shareholder vote. An institution newly participating in a generally available capital access program such as the Capital Purchase Program would only be required to submit its compensation to the vote if it wished to avoid the limits on compensation otherwise imposed by the guidance. It is possible that the stimulus bill will effectively eliminate the

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Golden Parachutes

- » Prohibition on making golden parachute payments to 5 senior executive officers and next 5 most highly compensated employees
- » Applies to *any* payment made upon *any* departure
- » Exception for payments for services performed or benefits accrued

salary cap in the guidance for such an institution, given the mandatory “say on pay” requirement.

Golden Parachutes

Prohibition. The stimulus bill prohibits an institution from making a golden parachute payment to any of its five senior executive officers and next five most highly compensated employees. A “golden parachute” payment is defined as any payment made upon departure from the institution for any reason, except for payments for services performed or benefits accrued. Presumably, “payments for services performed or benefits accrued” would pick up payments that would be made in all events, without regard to the nature of the departure.

Interaction with Guidance. The February 4 guidance, consistent with the financial stability legislation, defines a “golden parachute” more narrowly than the stimulus bill as a payment made due to an involuntary termination of employment or in connection with a bankruptcy, insolvency or receivership. In addition, the guidance only imposes an outright prohibition on paying golden parachutes to the top 10 senior executives of an institution that receives exceptional financial recovery assistance. The guidance further limits the amount of a golden parachute payable to certain executives who are not banned from receiving a golden parachute to not more than one times the executive’s average annual taxable compensation over the five-year period preceding the severance from employment. In the case of an institution that is participating in a generally available capital access program, under the guidance, the golden parachute limitation applies to the institution’s five senior executive officers. In the case of an institution that receives exceptional financial recovery assistance, the limitation applies to the institution’s top 25 senior executives who are not banned from receiving a golden parachute (*i.e.*, executives 11 through 35).

If the guidance and the stimulus bill are to be read together, the prohibitions and limits on golden parachutes would apply as follows:

- » An institution receiving any TARP assistance would be prohibited from paying any amounts (other than payments for services performed or benefits accrued) upon departure from the institution for any reason to its five senior executive officers and its next five most highly compensated employees.

Clawback

- » Clawback of incentives paid to 5 senior executive officers and next 20 most highly compensated employees, if based on materially inaccurate criteria

- » In addition, an institution that receives exceptional financial recovery assistance in the future must limit the amount of any golden parachute payment (as defined more narrowly in the guidance) to its next 25 senior executives to not more than one times the executive's average annual taxable compensation over the five-year period preceding the severance from employment.

Clawback

Requirement. The stimulus bill requires each institution to provide for the recovery of any bonus, retention award or incentive compensation paid to its five senior executive officers and its next 20 most highly compensated employees based on statements of earnings, revenues, gains or other criteria later found to be materially inaccurate.

Interaction with Guidance. The clawback requirement in the February 4 guidance is similar to the requirement in the stimulus bill in that it applies to bonus and incentive compensation paid to an institution's top 25 senior executives. However, the requirement in the guidance applies more narrowly with respect to the 20 senior executives below the top five in that the executive must have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate the executive's own incentive pay.

Luxury Expenditures

Policy Requirement. The stimulus bill requires an institution's board to have in place a company-wide policy regarding excessive or luxury expenditures, as identified by the Secretary, including excessive expenditures on entertainment or events, office and facility renovations, aviation or other transportation services and "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 institution.

Interaction with Guidance. The February 4 guidance requires an institution's board to have in place a luxury expenditures policy that is substantially similar to the one required by the stimulus bill. In addition, the guidance requires that the policy be posted on the institution's website and that the institution's chief executive officer certify any expenses that could be viewed as excess or luxury expenditures.

Risk Incentive Avoidance and Certification

- » Compensation of senior executive officers must exclude incentives to take unnecessary and excessive risks that threaten institution's value
- » Compensation committee of independent directors must meet semi-annually to discuss and evaluate any risk posed to institution by employee compensation plans
- » CEO and CFO must certify annually as to compliance with compensation requirements

Limits on Deductibility of Compensation

The stimulus bill, like the Capital Purchase Program, requires that an institution limit its annual deduction under Internal Revenue Code Section 162(m) for compensation paid to its five senior executive officers to \$500,000 per executive.

Manipulation of Earnings

The stimulus bill prohibits an institution's compensation plans from encouraging manipulation of the institution's reported earnings to enhance the compensation of any of its employees. As a result, the compensation committee and/or senior management will need to review plan design features and performance metrics to determine whether or not they could encourage such manipulation.

Risk Incentive Avoidance and Certification

Ban on Excessively Risky Incentives. Under the stimulus bill, as under the financial stability legislation, the compensation of an institution's senior executive officers must exclude incentives for the executives to take unnecessary and excessive risks that threaten the value of the institution. Neither the stimulus bill nor any Treasury guidance issued prior to its enactment provides direction as to the risks that might be deemed "unnecessary and excessive". The February 4 guidance requires an institution to eliminate incentives for all of its employees, not only for its five senior executive officers, to take such unnecessary and excessive risks.

Compensation Committee. The stimulus bill requires an institution to establish a compensation committee comprised entirely of independent directors to review employee compensation plans. No definition of or standards for determining independence appear in the statutory language, leaving open whether the government intends to promulgate independence requirements under TARP that are in addition to the standards currently promulgated by the SEC, the securities exchanges and the Internal Revenue Code.

The compensation committee is required to meet at least semi-annually to discuss and evaluate the institution's employee compensation plans in light of an assessment of any risk that such plans pose to the institution. The February 4 guidance, similar to the Capital Purchase Program, also requires the compensation committee to review promptly (within 90 days after receiving

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assistance) the compensation arrangements of both the institution's senior executives and its other employees with the institution's senior risk officers or other personnel acting in like capacity to ensure that their compensation arrangements do not encourage them to take unnecessary and excessive risks, and to meet at least annually with the senior risk officers to discuss and review the relationship between the institution's risk management policies and practices and the incentive compensation arrangements of its five senior executive officers.

Certification. The stimulus bill requires that an institution's chief executive officer and chief financial officer certify as to compliance with the compensation requirements of the stimulus bill. Public companies must provide the certification to the SEC, together with their annual filings. Private companies must provide the certification to the Secretary. The February 4 guidance requires the institution's compensation committee to certify annually that it has complied with the review requirements above, and the Capital Purchase Program guidance issued by Treasury on January 16, 2009 requires annual chief executive officer certification. Although not entirely clear, both certifications (the one from the chief executive officer and chief financial officer and the one from the compensation committee) may be required. In addition, the Capital Purchase Program proxy certification requirement presumably will continue to apply to participants in the program.

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For the text of the compensation provisions in the stimulus bill, click [here](#).

This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. To ensure compliance with requirements imposed by the Internal Revenue Service, we inform you that the discussion of U.S. federal tax issues contained in this memorandum is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. If you have questions about Treasury's recent initiatives or the executive compensation rules described above, please feel free to call your Davis Polk contact.

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This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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