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Law Update

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New TARP Executive Compensation Developments

The following items were recently issued regarding executive compensation restrictions for Troubled Asset Relief Program (“TARP”) recipient companies: (i) an IRS notice providing that a TARP equity acquisition is generally not a Code § 409A change in control; (ii) Treasury Interim Final Rules on the TARP Standards for Executive Compensation and Corporate Governance; and (iii) an SEC rule regarding a non-binding say-on-pay requirement for TARP recipient companies.

1. TARP Equity Acquisition Not a 409A Change in Control

The IRS recently issued Notice 2009-49 (June 4, 2009), <http://www.irs.gov/pub/irs-drop/n-09-49.pdf>, providing that an acquisition by the Treasury of equity in financial institutions under the TARP program will not be considered a change-in-control distributable event under Internal Revenue Code § 409A.

Under the Troubled Asset Relief Program of the Emergency Economic Stabilization Act of 2008 (“EESA”), as amended by the American Recovery and Reinvestment Act of 2009 (“ARRA”), the Treasury Department is authorized to make acquisitions of equity (e.g., common stock, preferred stock or warrants) in troubled financial institutions.

Under Code § 409A, nonqualified deferred compensation subject to § 409A may be distributed only on specified distribution events, as specified in the plan. One of the distribution events is a change in control as defined in Code § 409A(a)(2)(A)(v) and Treas. Reg. § 1.409A-3(i)(5).

Notice 2009-49 provides that an equity acquisition under TARP is not a change in control under § 409A. (As the notice states, to allow a TARP equity acquisition to be a distributable event under a 409A nonqualified deferred compensation arrangement would reduce liquidity and thereby be contrary to the purposes of EESA.)

- **Note:** The notice states that the plan document does not need to explicitly exclude TARP acquisitions from the definition of change in control.
- **Note also:** The notice does not address whether a TARP equity acquisition will be a change in control for other purposes. Therefore, change in control agreements may need to be amended to explicitly exclude TARP equity acquisitions.

2. Interim Final Rule on TARP Standards for Executive Compensation

Interim Final Rules Generally Supersede Prior Guidance. On June 15, 2009 the Treasury published Interim Final Rules on the TARP Standards for Executive Compensation and Corporate Governance, 74 Fed. Reg. 28394 (June 15, 2009) (the “Rules”), at 31 CFR (Money and Finance: Treasury) Part 30, <http://www.smartpdf.com/register/2009/jun/15/E9-13868.pdf>. These Rules, which apply to entities that receive financial assistance under the TARP program, are effective June 15, 2009, and supersede any previous guidance as of June 15, 2009. To the extent previous contractual provisions are not inconsistent with the Rules (e.g., the \$500,000 compensation deduction limit as discussed below), those contractual provisions remain in effect. 31 CFR § 30.17.

No \$500,000 Deduction Limitation Under These Interim Final Rules. EESA added Code § 162(m)(5), which provides that companies that sell more than \$300 million of assets in auction under TARP cannot deduct executive compensation in excess of \$500,000 for each of their senior executive officers. This provision only applies, however, if the \$300 million are sold in auction, and the Treasury has not done any auction purchases. However, under October 2008 interim final rules all TARP companies had to contractually agree to forgo deductions for compensation that would not be deductible if Code § 162(m)(5) were to apply. The current Interim Final Rules, however, do not require TARP companies to agree to apply the deduction limitations under Code § 162(m)(5). Thus, the \$500,000 deduction limitation would not apply. However, as stated above, any existing contracts with the \$500,000 compensation deduction cap prior to the release of the Rules must still be honored. Preamble to Interim Final Rules, 74 Fed. Reg. at 28396.

Bonus Payments to Senior Management Generally Prohibited During TARP Period. The Rules prohibit the payment or accrual of any bonus in a period during which any obligation arising from financial assistance under TARP remains outstanding (the “TARP Period”) to the five “senior executive officers” (the “named executive officers” identified in the company’s proxy disclosure) and to between one and twenty other highly compensated employees (depending on the level of TARP assistance). 31 CFR § 30.10. For example, for those institutions receiving over \$500 million in assistance, the five senior executive officers and the 20 other most highly compensated employees are subject to the bonus prohibition.

Bonus payment includes incentive compensation (whether cash or equity, and including options and SARs), as well as retention awards or transaction bonuses. § 30.1 (definitions of bonus, incentive compensation, retention awards, etc.)

Bonus payments do not include certain commissions for sales to, and investment management services for, unrelated parties. § 30.1 (definition of bonus). Bonus payments also do not include contributions to a qualified plan, benefits under a broad-based benefit plan, bona-fide overtime pay, and bona-fide and routine expense reimbursements. *Id.* Benefits under a nonqualified deferred compensation plan to the extent the amounts are accrued in the normal course of the employee’s service would generally be permitted. *Id.* The Rules contain an anti-abuse rule to prevent bonus make-ups in subsequent years for missed bonuses. § 30.10(c)(2).

There is also an exemption for bonus, retention award or incentive compensation even if they are legally binding right under an employment contract as of February 11, 2009. § 30.10(e)(2).

Restricted Stock and RSUs Permitted Subject to Specific Vesting Requirements Correlating to Repayment of TARP Financial Assistance. Awards of long-term restricted stock or restricted stock units will

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be permitted, and are not prohibited bonus payments, provided that the value of the grant does not exceed one third of the employee's annual compensation for that fiscal year. §§ 30.10(e)(1) & 30.1 (definition of long-term restricted stock). In addition, the vesting schedule must comply with the Rules, and specifically for each 25% of total financial assistance repaid, 25% of the total long-term restricted stock granted may vest, until the final repayment, at which time the remaining long-term restricted stock may vest. § 30.1 (definition of long-term restricted stock).

Prohibition on Severance (Golden Parachute Payments) During TARP Period. Pursuant to EESA as amended by ARRA, during the TARP Period there is a prohibition on severance payments to the top five senior executive officers and the next five most highly compensated employees. § 30.9. These severance payments are referred to by the Rules as golden parachute payments. However, for TARP the golden parachute payment need not be three-times salary (in contrast to excess parachutes under Section 280G of the Internal Revenue Code). A golden parachute payment includes any payment made to any of above top 10 employees on account of departure for any reason or on account of a change in control, unless paid for services performed or benefits accrued. § 30.1 (definition of golden parachute payment). Note that while ARRA limited the definition of golden parachutes to payments for an employee's departure, the Rules expand the definition of golden parachute payments to include payments made upon a change in control alone. *Id.* The golden parachute payment includes the value of any accelerated vesting due to departure or change in control. *Id.* The present value of all payments is treated as paid on the date of departure or change in control, and therefore TARP recipient companies may not avoid this restriction by deferring payment until after the TARP Period. *Id.* Golden parachute payments do not include payments from qualified retirement plans, payments due to death or disability, or certain deferred compensation plan payments. *Id.*

Clawback Under TARP of Bonuses that are Based on Materially Inaccurate Performance Data. Pursuant to ARRA, the Rules require that the TARP recipient companies must be able to recover (claw-back) any bonus paid to the five senior executive officers and then next 20 highest paid employees if such bonus payment has been based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria. § 30.8. A financial statement or performance metric criteria shall be deemed to be materially inaccurate with respect to any employee who knowingly engaged in providing (or failing to correct) inaccurate financial information. *Id.* The TARP recipient company must exercise its clawback rights unless it can demonstrate that it is unreasonable to do so, e.g., where the expense of enforcing the rights would exceed the amount recovered. *Id.*

Excessive / Luxury Expenditure Policy Certified by CEO & CFO Required for TARP Companies by 9/14/09. The Rules require that the board of directors of a TARP recipient company adopt a company-wide excessive / luxury expenditure policy. This policy (or any material amendments to this policy) must be filed with the Treasury and posted on the company's website within 90 days of the closing of the TARP agreement, or if later – by Sept. 14, 2009. § 30.12. The excessive or luxury expenditure policy must identify the reimbursement policy and procedures for (i) entertainment or events, (ii) office and facility renovations, (iii) aviation or other transportation services, and (iv) other similar items, activities or events. § 30.1 (definition of excessive or luxury expenditure policy). The CEO and CFO must certify that approval of any expenditure with respect to executives for which prior approval is required was properly obtained. *Id.*

Compensation Committee Review of Plans. TARP recipient companies must establish a compensation committee of independent directors. The committee must meet at least every six months (i) to ensure that the compensation plans covering the senior executive officers do not encourage taking unnecessary and excessive risk that threaten the value of the company, (ii) to review the employee compensation plans in general in light of the risks posted to the company by such plans and how to limit the risk, and (iii) to ensure that these plans do not

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encourage the manipulation of company reporting earnings to enhance the compensation of any employee. §§ 30.4, 30.5 & 30.6.

Annual Compensation Committee Certification (Part of Comp Committee Report). The compensation committee must provide annually a written description of how senior executive officers' compensation plans do not encourage taking unnecessary and excessive risks to the company, and that the above plans as well as all the compensation plans do not focus on short-term rather than long-term value creation. §§ 30.4(a)(4) & 30.7(a). The compensation committee must also certify annually the completion of reviews of the plans. §§ 30.4(a)(5) & 30.7(a). Once per year the compensation committee must provide a written description of how the above plans do not encourage unnecessary risk, etc. § 30.6(b). For public companies these certifications and disclosures must be included in the compensation committee report required by the S-K proxy disclosure rules. § 30.7(c).

Annual Certification of Compliance With TARP by CEO & CFO Within 90 Days After End of Fiscal Year. TARP and the Rules require that the CEO and CFO give an annual written certification of compliance with the TARP executive compensation provisions. This must be filed with the Treasury and with the company's primary regulatory agency – which in the case of a public company is the SEC. § 30.15. The certification must generally be made within 90 days of the end of the fiscal year. § 30.15(a)(2) & (3). The filing with the SEC should be as an appendix to the annual SEC Form 10-K. § 30.15(a)(4). Appendix A and Appendix B to 31 CFR § 30.15 provide model certifications for the first year and for subsequent years. There are about 16 items to certify.

Prohibition on Tax Gross-Ups For TARP Executives. Gross-ups of the five senior executive officers and the next 20 most highly compensated employees of a TARP recipient company may not be reimbursed for taxes owed relating to severance payments, perquisites or any other form of compensation. § 30.11(d). Certain international tax equalization agreements are allowed. § 30.1 (definition of gross-up).

Annual Perquisite Disclosure For Up to Top 25 Employees During TARP Period. TARP recipient companies must during the TARP period disclose annually to the Treasury and primary federal regulator any perquisite whose total value for the company's fiscal year exceeds \$25,000 for each of the top five senior executive officers and those additional highly compensated employees subject to the limit on bonus payments. § 30.11(b). The disclosure shall include a narrative description of the amount and nature of these perquisites, to whom they have been granted and a justification for offering these perquisites. *Id.* (Proxy disclosure in the past was only required for the top five named executive officers and did not require a narrative explanation.) Such perquisite disclosure will help the shareholders better understand why perquisites have been provided to executives and whether these perquisites are likely to maximize shareholder value.

Disclosure of Compensation Consultant. The Rules provide that a TARP recipient company must provide annually (within 120 days after the fiscal year) a narrative description to the Treasury and primary federal regulator of whether the company, the board or the compensation committee has engaged a compensation consultant, and all types of services that the compensation consultant or any affiliate has provided to the company in the past three years, including any "benchmarking" employed to identify certain percentile levels of compensation. § 30.11(c).

Special Master for Executive Compensation Under TARP.

Special Master. The Rules provide for Treasury to establish a Special Master for TARP Executive Compensation (the "Special Master") with responsibility for interpreting the executive compensation provisions of TARP. § 30.16. Kenneth Feinberg has been appointed as the first Special Master.

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Special Master to Review Compensation for Up to Top 125 Employees. The Special Master is responsible for reviewing and approving, with respect to TARP recipient companies who are receiving “exceptional financial assistance,” the compensation payments and compensation structure of the five senior executive officers and up to 20 of the other most highly compensated employees (i.e., those subject to the bonus restrictions in § 30.10). § 30.16(a)(3)(ii). In addition, the Special Master is to review the compensation structure of next 100 most highly compensated employees, with respect to the TARP recipient companies receiving exceptional assistance, who are not subject to the bonus restrictions. § 30.16(a)(3)(ii). “Exceptional financial assistance” includes any financial assistance provided under the following TARP programs: (i) Program for Systemically Significant Failing Institutions, (ii) Targeted Investment Program, (iii) Automotive Industry Financing Program, or (iv) any new program designated as providing exceptional financial assistance. § 30.1 (definition of exceptional financial assistance). As of the date of the Rules, seven companies were receiving exceptional financial assistance (AIG, Citigroup, Bank of America, Chrysler, GM, GMAC and Chrysler Financial). However, any TARP recipient company or employee may request an advisory opinion from the Special Master as to whether the compensation structure or payments are inconsistent with the purposes of § 111 of EESA or contrary to the public interest. §§ 30.16 (a)(3)(ii), 30.16(a)(4) & 30.16(c)(3).

Reviewing Pre-existing Agreements. The Special Master also reviews bonuses, retention awards and other compensation paid before Feb. 17, 2009 pursuant to § 111(f) of EESA to determine if any such payments were inconsistent with the purposes of TARP, and seeks reimbursement to the government where appropriate. § 30.16(a)(2).

Factors to Consider in Determining if Compensation is Inconsistent With TARP Principles. In reviewing compensation payments or compensation structures to see if they are inconsistent with the purposes of TARP or contrary to public interest, the following principles shall be applied: (i) avoiding excessive risk and incentives for short-term increases in value, (ii) taxpayer return as well as the need for the TARP recipient company to remain viable, (iii) appropriate allocation among each element of pay, (iv) compensation being based on individual and company performance, (v) comparable pay for similar employees at similar companies, and (vi) employee contribution to TARP company value. § 30.16(b)(1).

3. Voluntary Say on Pay Vote Must be Allowed for TARP Recipient Companies

On July 1, 2009, the SEC approved proposed amendments to the proxy rules for TARP recipient companies, which pursuant to EESA § 111(e) must permit a separate non-binding shareholder vote to approve the compensation of executives (say-on-pay) during the TARP Period. The proposed amendments, 74 Fed. Reg. 32474 (July 8, 2009), <http://www.smartpdf.com/register/2009/jul/08/E9-16037.pdf>, clarify this rule, providing in 17 CFR § 240.14a–20 that with regard to TARP recipient companies, the annual proxy soliciting directors shall also provide a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to Item 402 of Regulation S–K, including the compensation discussion and analysis, the compensation tables, and any related material.

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