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Executive Compensation Restrictions on TARP Recipients Under the Economic Stimulus Bill

On February 17, 2009, President Obama signed the American Recovery and Reinvestment Act of 2009 (the "Act") into law. The $787 billion stimulus bill includes an amendment and restatement of Section 111 of the Emergency Economic Stabilization Act of 2008 ("EESA"), expanding and strengthening executive compensation limitations for entities that have received or will receive governmental financial assistance under the Troubled Assets Relief Program ("TARP").[1] New regulations providing further guidance on the law are to be issued by the U.S. Department of the Treasury ("Treasury").

Under the Act, the Secretary of the Treasury is directed to require all entities receiving TARP assistance ("TARP Recipients") to "meet appropriate standards for executive compensation and corporate governance." Notably, TARP Recipients must comply with standards that, at a minimum, include a prohibition on severance payments, restrictions on bonus compensation, the implementation of mandatory clawback policies, a prohibition on compensation that encourages manipulation of earnings and a prohibition on incentives for unnecessary and excessive risks. In addition, TARP Recipients must establish wholly independent compensation committees, permit non-binding say-on-pay shareholder votes and adopt company policies limiting "luxury expenditures." The Act also restricts entities receiving assistance under EESA from hiring non-immigrant employees under the H-1B visa program.

The requirements of the Act modify existing provisions of Section 111 of EESA and introduce some entirely new obligations. The new statute raises a myriad of interpretive issues, and resolving these issues will require further guidance from Treasury and the Securities and Exchange Commission (the "SEC"). Moreover, the Act was introduced and passed only days after Treasury announced new executive compensation guidelines under EESA (the "Treasury Announcement"), many of which address similar concerns, and the White House has indicated that it intends to revisit the Act's executive compensation requirements with members of Congress.[2] An issue of immediate concern for TARP Recipients is whether the Act supersedes the Treasury Announcement or is intended to work in tandem with it.

[1] For more information on executive compensation under EESA and previously issued regulations related to EESA, please see the following Shearman & Sterling publications: "Executive Compensation Under the Emergency Economic Stabilization Act of 2008," available at www.shearman.com/eceb_100308, and "Executive Compensation Under the Emergency Economic Stabilization Act of 2008: A First Take on the Guidance," available at www.shearman.com/eceb_102108. For more information on other tax provisions contained in the Act, please refer to Shearman & Sterling's publication entitled, "Key Tax Provisions in the Economic Recovery and Reinvestment Act of 2009."

[2] White House Wants to Revise Compensation Part of Stimulus, New York Times (Feb. 16, 2009) at A-12.

The following chart summarizes the key provisions of the Act, the original executive compensation restrictions under EESA and the policies introduced in the Treasury Announcement.[3]

	Requirements Under the Act	Previous Policy Under EESA and Related Regulations and Guidance[4]	Policies Proposed in Treasury Announcement of February 4, 2009[5]
Overall Compensation Limitations	Prohibition on paying or accruing bonuses, retention awards or incentive compensation, except for long-term restricted stock that (i) does not fully vest until after the company has repaid the government, (ii) does not exceed 1/3 annual compensation and (iii) complies with other requirements imposed by Treasury regulations.[6] The prohibition is phased in to cover more individuals depending on how much assistance the TARP Recipient has received.	No limit on aggregate amount of compensation that can be paid to a senior executive officer ("SEO") or any other employee.[7]	Companies receiving exceptional assistance: Total compensation for SEOs limited to $500,000, other than restricted stock that vests after the company has repaid the government. Companies receiving general assistance: Either (i) total compensation for SEOs limited to $500,000, other than restricted stock that vests after the company has repaid the government or (ii) company must disclose compensation and, if requested, permit a say-on-pay shareholder vote.
Golden Parachutes	Prohibition on all severance for the SEOs and next five most highly-paid employees, except payments for services performed and benefits accrued.	Certain companies party to individually negotiated assistance programs and guidance for systematically significant failing institutions: Prohibition on severance for the SEOs. Other TARP Recipients: Severance for SEOs limited to 3x the SEO's base amount (determined under I.R.C. § 280G).	Companies receiving exceptional assistance: Prohibition on severance for any of the top 10 senior executives (SEOs plus the next five). The next 25 executives (other than the top ten) cannot receive severance exceeding the value of one year's base amount (determined under I.R.C. § 280G). Companies receiving general assistance: Prohibition on severance for SEOs exceeding the value of the SEO's base amount (determined under I.R.C. § 280G).
Deductibility of Compensation	No tax deduction for SEO compensation exceeding $500,000 per year.		

3 Certain provisions of the Act cover a specified number of individuals whose compensation has not been previously regulated under other executive compensation laws and regulations. Generally, each provision covers SEOs and a specified number of the "next most highly-compensated employees." This distinction is discussed in more detail below.

4 Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343; Treas. Interim Final Rule, 31 CFR Part 30; Treas. Notice 2008 PSSFI; Treas. Notice 2008-TAAP.

5 The Treasury Announcement distinguishes between entities that receive "exceptional assistance" and those receiving "general assistance." Entities receiving general assistance participate in programs that are available under the same terms for all recipients, while those receiving exceptional assistance have entered into bank-specific agreements negotiated with Treasury to provide more assistance than is allowed under a generally available program. Treas. Press Release TG-15 (Feb. 4, 2009).

6 The prohibition does not apply to any period during which the federal government only holds warrants to purchase common stock of the TARP Recipient. Bonuses required to be paid pursuant to an employment agreement executed prior to February 11, 2009 are also excluded from the prohibition.

7 The Act defines an SEO in the same manner as EESA as one of the top five most highly-paid executives whose compensation is required to be disclosed under the Securities Exchange Act of 1934. Treasury regulations related to EESA state that SEO has the same meaning as named executive officer ("NEO") as defined in Item 402 of Regulation S-K.

<table>
<tr><th></th><th>Requirements Under the Act</th><th>Previous Policy Under EESA and Related Regulations and Guidance[4]</th><th>Policies Proposed in Treasury Announcement of February 4, 2009[5]</th></tr>
<tr><td>Clawback Policies</td><td>Company must require that SEOs and next 20 most highly-paid employees repay bonus, retention awards or incentive compensation if the award is found to have been based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate.</td><td>Company must require that SEOs repay bonus or incentive compensation if the award is found to have been based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate. Treasury guidance added to the scope of the clawback profits from sales of the company's securities during 12 months following a materially non-compliant financial report.</td><td>Company must require that SEOs repay bonus or incentive compensation if the award is found to have been based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate. For the next 20 executives, company must require that executives repay bonuses if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay.</td></tr>
<tr><td>Review of Prior Payments</td><td>Treasury to review compensation of SEOs and the next 20 most highly-paid employees that was paid before the date of enactment of the Act. If any payments are found inconsistent with the purposes of the Act or contrary to the public interest, Treasury will seek to negotiate with the TARP Recipient and the employee for reimbursement.</td><td colspan="2">No provision.</td></tr>
<tr><td rowspan="2">Risk Assessment</td><td colspan="3">Companies must limit compensation to exclude incentives for SEOs to take unnecessary and excessive risks that threaten the value of the company.</td></tr>
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<tr><td>Prohibition on Encouraging Manipulated Earnings</td><td>Companies are prohibited from implementing compensation plans that "would encourage manipulation of the reported earnings" of the company to enhance the compensation of employees.</td><td colspan="2">No provision.</td></tr>
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	Requirements Under the Act	Previous Policy Under EESA and Related Regulations and Guidance[4]	Policies Proposed in Treasury Announcement of February 4, 2009[5]
Say-On-Pay	Until the government is repaid, any proxy for an annual meeting of shareholders must permit a separate non-binding shareholder vote on the compensation of executives as disclosed in proxy statement.	No provision.	Companies receiving exceptional assistance: Company must allow a non-binding shareholder vote on the senior executive compensation structure and rationale for how the structure is tied to sound risk management. Companies receiving general assistance: If requested, company must permit non-binding say-on-pay vote if pay exceeds the $500,000 SEO compensation limit.
Luxury Expenditures	Board must adopt a company policy related to approval of excessive or luxury expenditures as identified by Treasury.	No provision.	Board must adopt a company policy related to approval of luxury expenditures and post it on the company's website. Chief Executive Officer ("CEO") must certify any expenditure that "could be viewed as excessive or luxury items."
CEO and CFO Certification Requirements	CEO and Chief Financial Officer ("CFO") must provide written certification that the entity has complied with the Act. The certification must be made with the company's annual SEC filings or if it is not a public company, it must be provided to the Secretary.	CEO must certify that: (i) the compensation committee has met with senior risk officials in the company to ensure that compensation arrangements do not encourage SEOs to take unnecessary risks that threaten the value of the institution; (ii) the institution has instituted a clawback policy; (iii) the institution has prohibited golden parachute payments; and (iv) the company has instituted internal controls to limit tax deduction for compensation in excess of $500,000.	CEO must provide written certification that the institution has complied with all statutory, Treasury and contractual restrictions.
Restrictions on Withdrawal from TARP	Subject to consultation with the applicable federal banking agency, TARP Recipients are permitted to repay any assistance previously provided under TARP regardless of whether the TARP Recipient has replaced the funds from another source or whether any applicable waiting period has passed.	TARP Recipients are subject to a three-year waiting period during which they cannot repay TARP assistance unless the funds are replaced through a qualified equity offering.	No provision.

Restrictions Apply to More Entities and More Individuals

What Entities Are Covered?

The provisions of the Act apply to all TARP Recipients, including any entities that *have received or will receive* financial assistance under TARP. The retroactive application of the Act's standards distinguishes them from the provisions included in the Treasury Announcement, which would have applied only prospectively to companies that receive future assistance. The restrictions of the Act remain applicable to a TARP Recipient so long as any obligation arising from any financial assistance provided under TARP remains outstanding (excluding any period during which the federal government only holds warrants to purchase common stock of the TARP Recipient) (the "TARP Period").

In what appears to be an effort to ameliorate the potential retroactive application of the executive compensation rules, the Act permits TARP Recipients to repay any assistance previously received under TARP without replacing those funds through private financing.[8] As the new executive compensation restrictions go far beyond what companies agreed to in order to receive assistance under EESA, at least some companies might consider repaying previous assistance to avoid subjecting themselves and their employees to additional restrictions under the Act. Repayment, however, is subject to consultation with the company's federal banking regulators. In the current environment, it is unclear whether federal banking regulators will allow these institutions to repay the government without obtaining substitute private financing. To the extent that TARP Recipients are able to repay the government and withdraw from the program, it remains to be seen what impact such withdrawal would have on individuals whose compensation arrangements had been amended to comply with prior TARP requirements.[9] In any event, applying the new law to all TARP Recipients means that the Act will apply to many more entities than the restrictions in the Treasury Announcement.

Whose Compensation Is Regulated?

Certain of the executive compensation standards of the Act cover not only SEOs but also a specified number (depending on the provision) of the TARP Recipient's other "most highly-compensated employees." Where applicable, the extension to "employees" appears to cover individuals who are not executive officers, as long as their compensation brings them within the covered category. This means that the Act might cover individuals who do not have any policy-making functions for the company, including traders, portfolio managers and other employees who often represent the driving revenue forces of financial services companies.

The Act does not address (i) how a company should identify its most highly-compensated employees, (ii) what types of compensation should be considered when making that determination or (iii) how to deal with inevitable changes in the group of the most highly-compensated employees over multiple years.[10] Treasury guidance in the near term on these issues is critical. Our views on the implications of regulating the compensation of employees who are not executives will be discussed in more detail as they relate to specific provisions.

[8] The terms under which Treasury provided financial assistance under TARP generally included a three-year prohibition on the TARP Recipient repaying federal assistance except through offerings of securities to private investors. *See* Treasury's form of term sheet with terms that would govern agreements with companies under the Capital Purchase Program (the "CPP") (available at http://www.treasury.gov/press/releases/reports/termsheet.pdf).

[9] Careful drafting of the agreement by which executives or other employees consent to changes to their compensation arrangements can help ensure that these modifications are appropriately limited to what is required by the Act and apply only during the TARP Period.

[10] To avoid circularity, the determination presumably will need to be made on a retroactive basis, e.g., based on the prior year's compensation.

The following chart summarizes the applicability of the substantive executive compensation restrictions of the Act.

Restriction	Who is Covered
Prohibition on programs that encourage excessive risk taking.	SEOs.
Clawback of bonus, retention awards and incentive compensation based on statements of earnings, revenues, etc. later found to be materially inaccurate.	SEOs and any of the next 20 most highly-compensated employees.
Prohibition on golden parachute payments.	SEOs and any of the next five most highly-compensated employees.
Prohibition on bonus, retention awards or incentive compensation (other than long-term restricted stock, as detailed below).	Depends on amount of financial assistance: · Less than $25 million: highest compensated employee. · At least $25 million but less than $250 million: five most highly-compensated employees (or such higher number as determined by Treasury), · At least $250 million but less than $500 million: SEOs and 10 next most highly-compensated employees (or such higher number as determined by Treasury). · $500 million or more: SEOs and 20 next most highly-compensated employees (or such higher number as determined by Treasury).
Prohibition on plans that encourage manipulation of reported earnings.	All employees.

Executive Compensation Standards

Section 111 of EESA, as modified by the Act, requires Treasury to impose executive compensation standards on TARP Recipients that include, at a minimum, the following:

Severance Payments

TARP Recipients must be prohibited from making any golden parachute payment to an SEO or any of the next five most highly-paid employees during the time when the company has an outstanding obligation to the federal government. A golden parachute is defined as *any* payment to an SEO for departure from a company *for any reason*, other than payments for services performed or benefits accrued. This definition appears to be broad enough to encompass acceleration of vesting or lapse of restrictions on outstanding equity or other awards, as well as obligations to pay severance in the form of multiples of base pay and incentive compensation. This provision arguably also reaches pension enhancements that are triggered by an involuntary termination of employment. The prohibition on golden parachutes represents a significant expansion on the restriction of severance payments imposed by EESA and regulations thereunder in two respects.

First, regulations under EESA construed "golden parachute" payments to mean payments made on account of an involuntary termination of employment, or in connection with a bankruptcy filing, insolvency or receivership of the financial institution.[11] The Act explicitly enlarges the definition to apply to payments made in connection with a termination of employment "for any reason."

[11] *See* IRS Notice 2008-94, Q.12 (October 3, 2008); Treasury Interim Final Rule, 31 CFR Part 30, Q.9(b) (applicable to the CPP); Treasury Notice 2008 PSSFI, Q.9(b) (applicable to the program for Systematically Significant Failing Institutions) and Treasury Notice 2008-TAAP, Q.3(b) (applicable to the Troubled Asset Auction Program).

Second, for certain of the existing TARP programs, a termination payment would be treated as a golden parachute only to the extent that the aggregate present value of all such payments equals or exceeds three times the individual's base amount (determined in accordance with Section 280G of the Internal Revenue Code).[12] The Act scuttles this framework in favor of a blanket prohibition on all payments for departure from the TARP Recipient, with the exception of payments for services performed or benefits accrued.

As enacted, the prohibition on all golden parachutes could interfere with binding contractual obligations that TARP Recipients owe to executives and employees under agreements and compensation plans entered into before the adoption of the Act. While some executives and employees might be willing to amend their existing arrangements, others may not, and it is not evident whether the Act would provide a valid defense for a TARP Recipient that failed to honor a contractual undertaking entered into before the prohibition was enacted.[13] Another open question is whether the Act permits a TARP Recipient to accrue severance obligations during the TARP Period as long as payment is deferred until after the government has been repaid.[14]

Bonus, Retention and Incentive Compensation

TARP Recipients are prohibited from paying or accruing any bonus, retention award or incentive compensation during the TARP Period.[15] The lone exception allows companies to pay "long-term restricted stock" so long as it (i) does not "fully vest" until the government has been repaid, (ii) has value that does not exceed one-third of the employee's total annual compensation and (iii) complies with any other terms and conditions as determined by Treasury to be in the public interest.[16] The prohibition applies to a number of the most highly-compensated employees, depending on the amount of assistance received by the company, as indicated in the summary chart above.

The potential retroactive application of this restriction is limited by an exception for any bonus payment "required to be paid pursuant to a written employment contract executed on or before February 11, 2009."

One noteworthy feature of the prohibition is that it does not establish any cap or limit on the amount of salary that a TARP Recipient may pay to its SEOs or any other employee. Bonus (presumably including fixed or guaranteed bonuses) and incentive compensation are forbidden, but base salary is not mentioned in the Act.[17] Ironically, financial institutions subject

[12] The CPP and Troubled Asset Auction Program define "golden parachute" as an amount exceeding three times the applicable employee's base amount. *See* Treasury Interim Final Rule, 31 CFR Part 30, Q.9(a) and Treasury Notice 2008-TAAP, Q.3(a). For the program for Systematically Significant Failed Institutions, Treasury defined "golden parachute" as any payment on account of an applicable severance from employment. Treasury Notice 2008 PSSFI, Q.9(a).

[13] Some have raised the question of whether the retroactivity would raise issues under the U.S. Constitution, perhaps amounting to a deprivation of property without due process, in violation of the Fifth Amendment. These Constitutional issues have yet to be examined in depth, but as the provisions of the Act are applied, it will be interesting to observe whether companies or executives pursue such arguments.

[14] This same uncertainty existed under Treasury's interim final rules for the CPP under EESA. Treasury indicated in its *Frequently Asked Questions (FAQs)—Executive Compensation Requirements under the CPP* (Jan. 16, 2009) that any amount deferred until the government has been repaid would need to be "taken into account" to determine whether the three-times base amount threshold had been exceeded. The FAQs stopped short, however, of stating that amounts in excess of the threshold could not ultimately be paid, as long as payment was deferred until the company had repaid its obligations to the government. Even if permitted, any deferral would need to be structured either to be excepted from, or to comply with, Section 409A of the Internal Revenue Code.

[15] The explicit reference to "accruing" in connection with bonus and incentive amounts, and the absence of the term in the provision relating to golden parachutes, provides indirect support for the conclusion that a TARP Recipient may accrue golden parachute payments to its SEOs and next five most highly-compensated employees as long as actual payment is delayed until after the government has been repaid.

[16] Presumably the value of a restricted stock award would be calculated using the fair market value of the restricted stock on the grant date, but this will likely be clarified in forthcoming Treasury regulations.

[17] Current TARP Rules limit TARP Recipients' ability to deduct compensation paid to executives that exceeds $500,000 per year. Nonetheless, this limitation is of less immediate importance to financially distressed TARP Recipients that might have no taxable income in the current year.

to the restriction may feel compelled to significantly increase the base salaries of key employees to avoid violating the Act while remaining competitive with non-U.S. financial institutions and institutions that do not receive TARP assistance.[18] This approach runs counter to widely accepted compensation theories under which employees should be provided incentives to perform well and not be promised rewards that are independent of performance.[19]

As with the other executive compensation provisions of the Act, the prohibition on bonus and incentive pay raises a number of questions and uncertainties. Several that we feel deserve follow:

- As noted above, the number and identity of the individuals covered by the prohibition depend on the amount of government assistance that a TARP Recipient receives and can extend up to a total of 25 individuals for companies that receive at least $500 million in aid (the five SEOs plus the next 20 most highly-compensated employees). Identifying the correct universe of employees, then structuring compensation to avoid infringing the prohibition, will add complexity and is likely to distort compensation decisions. For example, arrangements for a key employee who in a given year is subject to the prohibition may need to be restructured to provide for a higher base salary rather than variable incentive compensation. If by the following year the individual has dropped out of the group subject to the Act's prohibition, the employee could again be eligible for an incentive program.
- Although bonuses "required" by employment agreements entered into before February 11, 2009 are exempted, it is unclear whether the exemption would reach employment agreements that give an executive the right to a bonus opportunity but leave to the board of directors or compensation committee discretion over the amount or form of bonus or the conditions under which it may be earned. In addition, many companies provide in employment agreements that certain employees will have the right to participate in various incentive compensation plans, but the actual employment agreements do not entitle the employees to a specific bonus award.[20]
- A TARP Recipient's ability to pay compensation under ongoing performance cycles where performance goals have been set and a payout matrix communicated to employees also remains uncertain.
- Some TARP Recipients may be in the position of having authorized and communicated incentive awards, such as stock options, prior to February 11, 2009, but may not have completed award documentation by that date. It is not clear how the Act will apply in this situation.
- The restricted stock exemption is limited to "long-term" restricted stock. Guidance will be required on what makes an award "long-term". This might refer to vesting requirements (although a multi-year framework is likely already ensured by the Act's requirement that the restricted stock not "fully vest" until the government has been repaid) or could contemplate requirements that employees hold restricted shares beyond vesting.

[18] Even this strategy, however, may be foreclosed if Treasury invokes discretionary authority under the Act to impose additional standards. In this connection, we note that the Treasury Announcement would impose a $500,000 limit on annual compensation for executives of companies receiving "exceptional assistance." The same limit would apply to companies participating in generally available programs but with the possibility to "opt out" of the limit by disclosing compensation practices and allowing a non-binding "say-on-pay" resolution to be voted on by shareholders. Integration of a $500,000 overall limit with the Act's exception for restricted stock with a value of no more than one-third of total annual compensation would effectively limit covered individuals to a total compensation package of $750,000, with $250,000 in restricted stock. Furthermore, there is a theoretical risk that even base salary increases could be viewed as prohibited "bonuses" or "retention awards" under the Act.

[19] One commentator has already noted that the ban on incentive compensation "work[s] against the logical, capitalist idea of offering incentives for workers to do a good job" and that "[t]he goal of compensation reform should be to ensure that pay is more closely linked to performance, not less so as the stimulus bill's provisions would require." Rob Cox, *Wall Street Does Need Incentives*, New York Times (Feb. 15, 2009) at B-2. *See also*, Lucian Bebchuk, *Congress Gets Punitive on Executive Pay*, Wall Street Journal (Feb. 16, 2009).

[20] It is the practice in many financial institutions to not have employment agreements other than with newly hired employees. It will be important to clarify whether the exception for existing employment agreements would extend to award agreements and other compensation plans.

- While restricted stock cannot "fully vest" during the period in which any obligation arising from TARP assistance remains outstanding, partial vesting appears to be acceptable. Guidance will be needed on how much vesting is permitted while obligations to the government remain outstanding.

The application of bonus restrictions to employees who are not executives will introduce acute challenges to financial services companies that customarily rely on incentive compensation to reward top-performing traders, portfolio managers and other non-executive employees. In addition, the restrictions may impede TARP Recipients' ability to recruit new hires since sign-on bonuses and other forms of initial recruitment compensation may be covered under the prohibition. In many respects, TARP Recipients will likely find themselves at a significant disadvantage in recruiting talent both with respect to domestic non-TARP Recipients and foreign financial services companies.

The new prohibition on bonus and incentive compensation reflects Congress' apparent frustration with compensation practices at financial institutions. While Congressional frustration is understandable, this provision constitutes a radical intrusion into the management of financial institutions and, to the extent it disadvantages TARP Recipients in the marketplace for talented employees, may prove counterproductive to the goal of stabilizing financial institutions who receive government assistance.

Clawbacks

The original version of EESA introduced clawback principles under which a financial institution must recover compensation paid to its SEOs if their bonus, retention award or incentive compensation is based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate. The Act extends this requirement beyond the SEOs to the TARP Recipient's next 20 most highly-compensated employees (a total of 25 employees). The Treasury Announcement had similarly expanded the original EESA clawback provision to reach the next 20 most-highly-compensated employees, but for the expanded group would have required a clawback only if the employees "knowingly engaged in providing inaccurate information relating to financial statements or performance metrics used to calculate their own incentive pay."

For TARP Recipients that receive at least $500 million in assistance, the clawback provision of the Act can be expected to apply principally to bonuses previously paid by the company, since the Act generally prohibits any future bonus, retention award or incentive compensation for the same group of employees to whom the clawback applies. For companies receiving less than $500 million in assistance, the clawback will have a broader reach than the prohibition on incentive compensation. It is unclear whether a bonus that is earned and paid during the TARP Period would remain subject to the clawback even after the TARP Period has ended.

Other Requirements

As under the original version of EESA, TARP Recipients must structure compensation arrangements to exclude incentives for SEOs to take unnecessary and excessive risks that threaten the value of the company while the company has outstanding obligations to the government. While this provision applies only to SEOs, the compensation committee is still required under the Act to evaluate all employee compensation plans in light of the risks posed to the TARP Recipient by such plans.

In addition, companies are prohibited from implementing compensation plans that "would encourage manipulation of the reported earnings" of the company to enhance the compensation of employees. TARP Recipients must also establish a compensation committee comprised of entirely independent directors for the purposes of reviewing employee compensation plans. While publicly traded companies will already have a compensation committee composed of independent directors in order to comply with NASD or stock exchange rules, many such committees are responsible for reviewing and approving executive compensation only. The Act appears to broaden this mandate to require review of compensation plans for employees generally.

We note that the Act clearly states that these standards are the minimum of what Treasury must require of TARP Recipients. It appears that Treasury may adopt additional restrictions on aspects of compensation not covered in the Act. The Act leaves an extraordinary amount of discretion with Treasury to expand on the standards set forth above.

Additional Company Requirements

In addition to complying with the Treasury standards described above, the Act imposes the following requirements on all TARP Recipients:

- ***Say-On-Pay.*** TARP Recipients must implement a say-on-pay policy, allowing for an annual non-binding shareholder vote on executive compensation as disclosed pursuant to the SEC's compensation disclosure rules. The SEC has been directed to issue final rules implementing this requirement by the first anniversary of the Act's enactment. Thus, the requirement should not apply to proxy statements for annual meetings of shareholders held in 2009.

  The Act itself does not appear to impose any sanctions if shareholders reject the company's executive compensation structure, but it is conceivable that Treasury could use a negative say-on-pay vote to impose further limitations on companies that are negotiating for exceptional assistance. A negative vote could also result in pressure from institutional and other shareholders and would likely garner bad press for the TARP Recipient as well.

- ***Luxury Expenditures.*** The board of directors must adopt a company policy related to the approval of excessive or luxury expenditures, as identified by Treasury, including corporate aircraft, office and facility renovations, entertainment and holiday parties and other activities or events that are not reasonable expenditures for staff development, performance incentives or similar measures in the normal course of business. The Treasury Announcement also provided for a similar policy on luxury expenditures and specified that the policy be posted on the company's website and that the CEO certify any expenditures that "could be viewed as excessive or luxury items." When Treasury releases regulations under the Act, it may impose similar requirements.

  The definition of luxury expenditures is different from the standard for identifying perquisites for purposes of SEC disclosure, and various items that would not be disclosed as perquisites under SEC rules (because they are integrally related to the performance of employment duties) could fall within the new restrictions on luxury expenditures.[21] An executive's travel on a company-owned plane to attend a business meeting, for example, would generally not be considered a perquisite for SEC disclosure purposes but would need to be addressed by the required policy on luxury expenditures. With this provision, Congress seems to be announcing that, at least in some respects, employees of a TARP Recipient should be held to standards similar to those that apply to civil servants, who have traditionally been subject to a high level of scrutiny and restrictions with regard to expenditures.

- ***Certification Requirements.*** The CEO and the CFO must provide written certification that the TARP Recipient has complied with the Act. The certification must be made with the company's annual SEC filings, or if it is not a public company, it must be provided to Treasury. Interim Rules released by Treasury in January 2009[22] make the

[21] Perquisites for purposes of SEC disclosure generally contemplate benefits to employees that are not integrally and directly related to the performance of a person's job responsibilities or that confer direct or indirect benefits that have a personal aspect.

[22] Treasury Interim Final Rule, 31 CFR Part 30, RIN 1505-AC09, Q.6 (applicable to the CPP).

point that CEO and compensation committee certifications are within the scope of 18 USC § 1001, which imposes criminal sanctions on persons making certain fraudulent statements to a federal official.[23] Although not mentioned in the Act, we expect that these criminal sanctions may apply to the new certification requirements as well, at least in the case of non-public TARP Recipients. There is also a possibility of securities law liability for certifications that are to be made in a filing with the SEC.

A key issue that requires immediate consideration is whether the certification requirement applies to annual reports for the 2008 fiscal year. For those companies whose fiscal year ended December 2008, the deadline for filing the annual report on Form 10-K will generally be March 2, 2009.

EESA already required the compensation committee and the CEO to certify that the TARP Recipient's compensation committee has met with senior risk officials in the company to ensure that compensation arrangements do not encourage SEOs to take unnecessary risks that threaten the value of the institution. The status of this requirement is also uncertain under the Act.

- ***Prohibition on Hiring Non-immigrant Workers.*** The Act includes a provision outside of the executive compensation section that prohibits any company that receives assistance under EESA from hiring any non-immigrant workers under the H-1B visa program for two years unless the company qualifies as an H-1B-dependent employer. An H-1B dependent employer must fall into one of the following three categories: (i) the company has 25 or fewer full-time equivalent employees in the United States and employs more than seven H-1B non-immigrants; (ii) the company has between 25 and 50 full-time employees in the U.S. and employs more than 12 H-1B non-immigrants or (iii) the company has more than 50 full-time employees in the U.S. and at least 15 percent of its U.S. full-time employees are H-1B non-immigrants.[24] This provision, while so far attracting little media coverage, is significant given that many TARP Recipients rely on non-immigrant employees to fill their workforces. Like many other provisions in the Act, this prohibition will likely place TARP Recipients at a disadvantage in maintaining an adequate qualified workforce. We expect this issue to garner more attention as the Act is implemented.

Review of Prior Payments

One of the more remarkable aspects of the Act is that it requires Treasury to review bonus, retention awards and other compensation paid to SEOs and the next 20 most highly-paid employees of each TARP Recipient that received assistance before the effective date of the Act to determine whether the payments were inconsistent with the purposes of the executive compensation provisions of the Act or TARP, or were otherwise contrary to the public interest. If Treasury determines that any of these payments were inconsistent with the Act or TARP or were contrary to the public interest, then Treasury must negotiate with the TARP Recipient and the employee for reimbursement of the compensation to the federal government.

There is no indication of what would constitute compensation that is inconsistent with the Act or with TARP, or what would rise to the level of being contrary to the public interest. The provision is somewhat less stringent than the Senate version, which would have allowed Treasury unilaterally to demand reimbursement of bonuses that it deemed excessive. The Act implicitly acknowledges that Treasury would need the consent of both parties to a compensation agreement in order to

[23] The status of the January Interim Rules is uncertain, as they appear to have been within the scope of the Obama administration's general directive for regulatory agencies to withdraw regulations that had not appeared in the Federal Register as of January 20, 2009. *See* Memorandum to the Heads of Executive Departments and Agencies, 50 Fed. Reg. 44359 (January 26, 2009) (available at http://media.washingtonpost.com/wp-srv/politics/documents/emanuel-regulatory-review.pdf).

[24] The Immigration and Nationality Act (the "INA") permits companies to hire skilled non-immigrant employees by applying for H-1B visas for such employees. The INA makes a distinction between "H-1B-dependent employers" and other employers. *See* Sections 101(a)(15)(h)(i)(b) and 212(n) of the INA.

retroactively rescind a bonus and demand repayment. Nonetheless, given that Treasury has a great deal of discretion under EESA and the Act to grant or deny aid and to impose stricter regulations on TARP Recipients, it would seem that Treasury will have a heavy hand in negotiations.

Conclusion

The passage of the Act's executive compensation provisions continues the experiment that Congress initiated with the original version of EESA by intruding into an area – executive compensation – that historically has been regulated under state law. Moreover, the fact that provisions of the Act cover employees who are not executives imposes obligations on the board of directors and compensation committees to review general employment policies that have historically been reserved for companies' management teams. Nonetheless, the provisions will likely be welcomed by those who believe that the initial programs under EESA did not successfully address abusive compensation practices.

Going forward, it will be crucial to watch how Treasury expands, or narrows, the new law in its forthcoming regulations. Preliminary news reports seem to suggest that Treasury may seek to narrow the scope of the new restrictions. It remains unclear whether Treasury will encourage or require companies to impose an overall pay cap on executives, but given the large amount of discretion given to Treasury under the Act, some sort of total limitation seems to be within the scope of its authority. In addition, the extent to which bank regulators allow TARP Recipients to withdraw from the program will be important, as it will likely determine the competitive landscape for executive talent. If some companies are able to withdraw from TARP, they will be at a significant advantage in capturing talent from other TARP Recipients.

While we wait for Treasury and SEC guidance to fully understand the practical application of the new law, TARP Recipients will need to take immediate steps to begin planning the restructuring of their top compensation arrangements. TARP Recipients will face a number of new challenges as they attempt to walk the fine line between satisfying compensation restrictions and recruiting and retaining a talent pool with the experience and skill to lead these institutions out of the current crisis.

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