COMPENSATION RESTRICTIONS UNDER THE LATEST STIMULUS PLAN: MORE QUESTIONS THAN ANSWERS

After 25 years of largely counterproductive efforts to restrain executive compensation, it appears Congress has finally run out of patience, replacing tax disincentives with outright prohibitions on offending pay practices as the preferred method of attacking the disparity between top executive and average worker pay. However, the last-minute compensation provisions of the American Recovery and Reinvestment Act of 2009 (ARRA) represent more a frustrated, broad-brush, and in some respects ill-conceived, response to incentive compensation that continued to reward executives as the financial industry imploded, than a thoughtful and workable solution.

Applying ARRA's compensation rules may prove to be a challenge: the statute includes few definitions, provides no delayed effective dates, is subject to multiple reasonable interpretations as to many aspects of its operation, and gives the Secretary of the Treasury broad latitude to promulgate whatever regulatory standards are thought to be appropriate, regardless of what the statute says. In general, the rules seem to be effective immediately and may in some cases have retroactive effect. Covered institutions will need to figure out who is a covered employee, set pay levels, restrict departure payments, and file proxy statements before regulations are issued.

ARRA Limitations and Standards

For covered employees at the more than 400 institutions that have received federal assistance to date under the Troubled Asset Relief Program (TARP) and those that will receive assistance in the future, ARRA creates startling new pay limitations and standards that will continue to apply until the assistance is paid back. Furthermore, ARRA did away with the distinction in treatment between direct purchase and auction purchase TARP recipients, as was established under the Emergency Economic Stabilization Act of 2008 (EESA); therefore, the following principal limitations on the compensation paid to covered employees of all TARP recipients apply under ARRA:

- a general prohibition on accruing or paying any bonus, retention award, or incentive compensation unless paid in the form of restricted stock that represents no more than one third of an individual's total annual pay and that may not fully vest during the period in which any obligation arising from financial assistance provided under TARP remains outstanding;
- the expansion of the definition of "golden parachute payment," so that no severance payments can be paid to a covered employee on departure for any reason, unless the payments are "for services performed or benefits accrued";
- limits on compensation that exclude incentives for covered employees to take unnecessary and excessive risks that threaten the value of their employer;

- policies to claw back any bonus, retention award, or incentive compensation paid to covered employees that is based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and
- a general prohibition on compensation plans that encourage manipulation of reported earnings to enhance the compensation of any employees.

In addition, ARRA created the following new standards to promote greater accountability to shareholders and to the federal government:

- The board of directors of each TARP recipient must establish a new "Board Compensation Committee," composed of independent directors, to meet at least semiannually and assess the risks posed by the institution's employee compensation plans.
- The board of directors of each TARP recipient must implement a company-wide policy regarding payment of excessive or luxury expenditures, as identified by the Secretary of the Treasury.
- TARP recipients must permit in their proxy or consent for authorization for any shareholder meeting a nonbinding shareholder vote on the named executive officer compensation disclosed therein.
- The chief executive officer and chief financial officer of each publicly traded TARP recipient must provide to the Securities and Exchange Commission (SEC) a written certification of compliance with the new standards. Private companies must make the same certification to the Secretary of the Treasury.

Application of the Limits and Standards

In concept, the new limitations and standards seem straightforward. In practice, this executive compensation legislation seems likely to have unintended consequences. This is not a new phenomenon for executive compensation legislation, but the stakes here are perhaps higher since financial institutions that need help are being handicapped.

Retention Issues

One practical reality appears to have been ignored – given the current economic climate and financial situation of TARP recipients, now is exactly the time that recruiting and retention of top performers is most important. The new ARRA limits on incentive compensation and the complete prohibition on the payment of cash bonuses will do an excellent job of preventing underperformers from being overcompensated, but they will also insure that top performers (who are most likely to be covered employees) are under-compensated, because all covered employees will generally be paid without regard to individual performance. Given these constraints, recruiting and retaining top performers will present a difficult challenge at a time when top people are most needed. This short-sightedness may ultimately leave a TARP recipient with no other choice but to provide market levels of pay through staggering amounts of base salary.

While such non-incentive-based compensation will continue to be subject to the $500,000 deduction limit of Internal Revenue Code Section 162(m)(5) for covered employees, given the loss position of many TARP recipients, deduction limits are not likely to trump recruiting and retention concerns, and the reduction in loss carry-back will further penalize institutions that need help. Another odd but entirely predictable result is that by precluding the use of normal performance-based incentive compensation, the incentive to perform may also be reduced. Perhaps we will see retention objectives being facilitated by imposing vesting schedules on base compensation.

Scope of Coverage

The next set of issues involves the determination of covered employees, which is an elastic concept. Most of the rules apply to an institution's "senior executive officers" (SEOs), who are the top five most highly paid executives of a public company whose compensation is required to be disclosed under the securities laws, and their nonpublic company counterparts. The scope of most of the limitations and standards is fixed: the "no severance" rule applies to SEOs and the next five most highly compensated employees;[1] the limits on incentive compensation that exclude incentives to take unnecessary and excessive risks apply only to SEOs; and the requirement to recover bonuses based on materially inaccurate information applies to SEOs and the next 20 most highly paid employees. The scope of the incentive/bonus limits depends on the amount of TARP assistance received. If assistance is less than $25 million, only the most highly compensated employee is covered. If assistance is at least $500 million, all SEOs and at least the next 20 most highly compensated employees are covered. The number of covered employees scales down for intermediate levels of assistance, but in the case of all institutions receiving at least $25 million in assistance, the number of covered employees can be increased if the Secretary of the Treasury determines that to be in the public interest.

Notwithstanding the general scope of each limitation and standard, ARRA directs the Secretary of the Treasury to review bonuses, retention awards, and other compensation paid to SEOs and the next 20 most highly compensated employees of each entity that has already received TARP assistance prior to February 17, 2009, to determine whether any such payments were inconsistent with the standards set forth above or were otherwise contrary to the public interest, in which case the Secretary is further directed to seek to negotiate with both the TARP recipient and the employee for appropriate reimbursement. This broad-based, seemingly unlimited directive could permit the Secretary of the Treasury to go beyond the scope of the rules above to claw back amounts paid to any employee of a TARP recipient, putting them at a competitive disadvantage to even those institutions that become subject to the general ARRA rules by participating in TARP after February 16, 2009.

The determination of SEOs creates its own problems. While the definition of SEOs has generally been interpreted (and refined further in pre-ARRA guidance under EESA) to mean the "named executive officers" as disclosed in a public company's proxy statement (i.e., the principal executive

[1] Interestingly, ARRA defines "golden parachute payment" as a payment to an "SEO," which begs the question of how a payment to any other employee (i.e., one of the next five most highly compensated employees) could ever be deemed a "golden parachute payment."

officer, principal financial officer, and three most-highly paid "executive officers"), a literal read of the definition in the statute creates an interesting interpretive question by the inclusion of both the top-five concept and the public disclosure concept. Without clarification that the pre-ARRA guidance continues to apply, one might read this definition to mean that as long as there are five non-executives whose compensation is in excess of the named executive officers, there are no SEOs.

Beyond that, ARRA does not address the question of when the determination of the SEOs is to be made, though one could again assume that this would track the pre-ARRA guidance issued under EESA, since the definitions of SEO are largely the same in both statutes.[2] Under this approach, SEO status for the current fiscal year would be based on compensation received with respect to the prior fiscal year. Thus, 2009 covered employee status may be dependent on calculation and payment of 2008 bonuses. This rule is perplexingly circular. For securities laws purposes, a bonus paid in one year for a prior year is generally considered compensation for the prior year. Where a 2008 bonus might otherwise create SEO status, ARRA may prevent the payment of that bonus in 2009. In that case, the executive's compensation might no longer be subject to disclosure under the securities laws, or his total compensation could drop below the threshold for SEO status, in which case such bonus would seem to be payable. Similar issues could arise in regard to the determination of non-SEO covered employees generally.

In any case, unlike covered employee status under Internal Revenue Code Section 162(m)(5), covered employee status for the ARRA limitations and standards will need to be tested annually, which also creates an interesting dynamic. Suppose an individual is a covered employee in Year 1, such that compensation is required to be limited as a result of the ARRA rules. For the following Year 2, it is reasonable to believe that as a result of the depressed compensation for Year 1, such individual will no longer be a covered employee in Year 2, meaning the limits will no longer apply with respect to Year 2 compensation, and there could be new players in the set of covered employees for such year. In that event, a TARP recipient's covered employees may be eligible to receive uncapped compensation every other year as a result of falling in and out of covered employee status.

Preexisting Contracts

Another pressing question, both for covered institutions and for a potential covered employee considering whether to accept employment with or a promotion within a TARP recipient, is how to deal with preexisting and ongoing bilateral contractual commitments entered into with an employee who could potentially become a covered employee in a later year. This will be especially problematic if the covered executive has deferred compensation that is otherwise required to be paid in a year in which ARRA prohibits the payment from being made. Employment contracts and other compensation plans may need to include standard, boilerplate TARP override payment limitations.

[2] *See* Frequently Asked Questions (FAQs) Executive Compensation Requirements under the Capital Purchase Program (CPP), *at* http://www.treas.gov/press/releases/reports/tarp%20_executive%20compensation%20faqs.pdf.

Say-on-Pay Shareholder Vote

For TARP recipients that are public, the say-on-pay requirements pose perhaps the most pressing issues, in that most public companies are currently working on their proxy statements in connection with their 2009 annual meeting. While ARRA has tasked the SEC with preparing final guidance no later than February 2010, a plain reading of the relevant ARRA provision as well as limited SEC guidance to date suggest that the rule is already in effect and that a TARP recipient must permit a nonbinding vote on compensation in the current proxy. The SEC guidance also clarified the meaning of “must permit,” providing that the vote is an affirmative requirement rather than conditioned on receipt of a shareholder proposal.

Nonetheless, there remain open questions as to what must be approved in such a vote: the total compensation package for all executives, specific elements of that package, or individual compensation (such that one could vote yes on the CEO’s compensation but no on the CFO’s compensation). These are all difficult questions that cannot be answered without further guidance, leaving those TARP recipients that find themselves in the middle of proxy preparation in somewhat of a predicament.

Other Issues

ARRA requires that a new “Board Compensation Committee” of a TARP participant’s board must meet semiannually to assess the risks posed by an institution’s employee compensation plans. This requirement is seemingly limitless in its application, meaning it would require such a committee to review all compensation plans, regardless of to whom they apply. For large TARP participants with many employees and complex compensation structures, this could be a daunting task.

ARRA also requires each TARP recipient to implement a company-wide policy regarding payment of excessive or luxury expenditures; however, no guidance is given as to what such a policy should provide.

Although ARRA did not revise the EESA amendment to Internal Revenue Code Section 280G (which limits the deductibility of “excess parachute payments” made to SEOs), the ARRA standards and this provision are not mutually exclusive from one another in operation. Although not acknowledged by the statute, ARRA’s absolute prohibition on the payment of “golden parachute payments” renders meaningless the relatively new Section 280G limit on the deductibility of such payments, since none may be made.

Some Final Thoughts.

One of the first steps a TARP recipient’s board will need to consider is whether to pay back prior TARP assistance (a step that ARRA specifically allows) to avoid putting its company at an enormous competitive disadvantage, especially in light of another interpretive question, which is, how long the standards and limitations will continue to apply (or in other words, when an obligation arising from TARP participation ceases to be outstanding). Although ARRA clarifies that the period in which any obligation arising from financial assistance provided under TARP remains outstanding does not include any period during which the Treasury holds only warrants to purchase common stock of the TARP recipient, the question remains as to what might be considered an "obligation arising from financial assistance provided under TARP," such as whether this would include any subsequent private debt issuance, the proceeds from which are used to satisfy a TARP obligation to the Treasury.

For TARP recipients for which immediate repayment of TARP assistance is not feasible, time will tell whether the best people will stick around to participate in the recovery. In the meantime, the net effect of ARRA's new compensation limits will be to increase dramatically the scrutiny on compensation committees, which will face more pressure than ever before to make value judgments about overall compensation levels and to try to differentiate between fair and windfall compensation. For SEOs and the next 20 covered executives who have already received high rewards while their institutions floundered, there will be mounting public and perhaps government pressure to give something back. It will be an interesting laboratory experiment to watch unfold.

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