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# TARP & Executive Compensation Limits

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# Webinar Agenda



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- ★ Our goal is to review the executive compensation provisions within the American Recovery and Reinvestment Act of 2009 (“ARRA” or the “Stimulus Bill”)
  - What do we know at this point in time?
  - What questions are we seeking guidance on?
  - Most importantly, how are banks responding to ARRA.

# Webinar Topics

- ★ Effective date
- ★ Employee definitions
- ★ Variable based pay
- ★ Claw back provisions
- ★ Excessive/Earnings risk
- ★ Independent compensation committee
- ★ Post-termination payments
- ★ \$500,000 deduction cap
- ★ Luxury expenditures
- ★ Review of prior payments
- ★ Say-on-Pay vote
- ★ Compliance certification
- ★ Special TARP withdrawal

***What do we know?  
What questions do we have?  
What are banks doing?***

# The Stimulus Bill & Executive Compensation



# Effective Date

## ★ *The Law*

- Section 111 of the Emergency Economic Stabilization Act of 2008 is amended
- Establishment of Standards: During the period in which any obligation arising from financial assistance provided under the TARP remains outstanding (the preferred stock), each TARP recipient shall be subject to –
  - (a) the standards established by the Secretary under this section; and
  - (b) the provisions of section 162(m)(5) of the IRC of 1986 as applicable.

## ★ *Questions*

- Are the standards (limitations) applicable now?
- Or, are they on hold until “established” by Treasury?

## ★ *Observations*

- Many pay decisions and actions on hold until we get an answer.

# Employee Definitions

## ★ *The Law*

- Senior Executive Officers (SEO): Defined as 1 of the top 5 most highly-paid executives of a public company whose compensation is required to be disclosed pursuant to SEC regulations and non-public counterparts. Existing Treasury guidance defined these as “proxy officers” or “named executive officers.”
- Highly Compensated Employee (HCE): Not limited to SEOs or other executive officers.

## ★ *Questions*

- Will CEO and CFO still be SEOs, even if other executive officers were higher paid?
- What “compensation” is counted to create a ranking of HCEs? Is it “proxy compensation,” W-2 pay or a combo?
- What is the measurement period? Once an SEO, always an SEO?

## ★ *Observations*

- Note distinction in employee definitions, these definitions matter!

# Variable Based Pay

## ★ *The Law*

- TARP participants are prohibited from paying or accruing any bonus, retention award or incentive compensation to a range of individuals, depending on the amount of TARP assistance as set forth below. Note that the new guidance reaches beyond Senior Executive Officers (SEOs) and includes “highly-compensated employee(s).”
- The number of HCEs impacted is scaled to the size of the Treasury’s preferred stock purchase and subject to Treasury discretion. Note, beginning at \$25 million of TARP participation, the number of officers that are covered represents a minimum, Treasury may increase number of officers covered.

<u>AMOUNT OF ASSISTANCE</u>	<u>INCENTIVE COMPENSATION RESTRICTIONS APPLY TO:</u>
Less than \$25 million	The most highly-compensated employee (1 officer only)
\$25 million but less than \$250 million	At least the 5 most highly-compensated employees (Minimum 5)
\$250 million but less than \$500 million	SEOs plus at least the next 10 most highly-compensated employees (Minimum 15)
\$500 million or more	SEOs plus at least the next 20 most highly-compensated employees (Minimum 25)

- The prohibition [on incentive compensation] does not apply to the granting of long-term restricted stock provided that the equity (a) does not fully vest during the period the TARP preferred remains outstanding, (b) has a value not greater than 1 / 3 of the total annual compensation of the recipient and (c) is subject to other terms and conditions that may be determined by the Treasury to be in the public interest.

# Variable Based Pay - Continued

## ★ *Exceptions*

- Prohibition does not apply to “any bonus payments required by a written employment contract executed on or before February 11, 2009.” Treasury is to determine what is a written employment contract. Note absence of reference to “retention awards” or “incentive compensation.”
- Prohibition does not apply to a complying award of restricted stock that does not fully vest until the TARP preferred stock is fully redeemed.

## ★ *Questions*

- When and how are HCEs determined? Will Treasury expand the number?
- Does the “grandfather” for written contracts only apply to bonus pay?
- How is “annual” compensation defined for the restricted stock limit? What does “fully vest” mean?
- What “other terms and conditions” will be applied? Is a service condition required?
- Is the use of stock options precluded in any situation?

## ★ *Observations*

- Banks are already discussing increases in base salary to offset variable limitation.
- Impact on producer plans will be dramatic. Potential significant impact on community-based banks.
- Effective date is critical here, as is determination of HCEs
- Significant impact on traditional executive compensation program design

# Claw Back Provisions

## ★ *The Law*

- TARP recipients must be able to recover any bonus, retention award or incentive compensation paid to CEOs and any of the next 20 most highly-compensated employees (up to 25 employees) based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate.
- Expands the reach of the “clawback” to 25 from 5 under the original TARP rules. Applicability to top 25 applies to all TARP recipients; not scaled to amount of TARP funds received.

## ★ *Questions*

- When does the expansion to 25 become effective?
- What is the best way to establish the right of recovery?

## ★ *Observations*

- May be easiest to provide clawback provisions in all bonus, retention and incentive plans to assure nothing slips by.
- Interpretation of what constitutes “materially inaccurate” will affect the reach of the clawback.

# Excessive/Earnings Risk

## ★ *The Law*

- Compensation plans must exclude incentives for Senior Executive Officers to take unnecessary and excessive risks that threaten the value of the company. Changes existing TARP rules from a simple review by the compensation committee to a prohibition on any such incentives.
- Prohibition on any compensation plan that would encourage manipulation of the reported earnings to enhance the compensation of any employee.

## ★ *Questions*

- Does “no manipulation” provision effectively preclude bonus and other plans based on net income, EPS or a similar metric? Or, is it broader and could be meant to preclude any income statement oriented metric?

## ★ *Observations*

- If viewed expansively, the no manipulation provision could bar almost all financial performance-based compensation programs throughout the organization.
- If so, institutional shareholder reaction will be interesting.

# Independent Compensation Committee

## ★ *The Law*

- Each TARP recipient must establish a compensation committee comprised entirely of independent directors for the purpose of reviewing compensation plans.
- The committee must meet at least semi-annually to discuss and evaluate the employee compensation plans in light of an assessment of any risk posed to the TARP recipient from such plans.
- If not public and received less than \$25 million in TARP funds, duties of the committee may be carried out by the full board of directors.

## ★ *Questions*

- How will “independence” be determined? NYSE and NASDAQ rules, or Section 162(m) “outside director” rules?
- Does “employee compensation plans” mean all plans, including broad-based health, retirement, and retiree plans, or just executive compensation plans? Are the present and future costs of those plans one of the “risks” to be evaluated?

## ★ *Observations*

- Committee conclusions after review will need to be documented and supported, even if conclusion is “no change” to any of the compensation plans.

# Post-Termination Payments

## ★ *The Law*

- TARP participants are prohibited from making any golden parachute payments to Senior Executive Officers and the next 5 most highly-compensated employees (up to 10 total employees) during the period in which the preferred stock remains outstanding.
- Golden parachute payments are now defined as any payment for departure from a company for any reason, except for payments for services performed or benefits accrued.
- Original TARP only limited the amount of payments on involuntary/good reason termination to the traditional golden parachute limit of three times five-year average pay.

## ★ *Questions*

- Is this a “get in line” provision meaning the payment is delayed until TARP is paid off, or that the payment is permanently barred?
- When are benefits accrued?

## ★ *Observations*

- No golden “good byes”
- Significant change for those who already have TARP funds.
- Significant questions about bank’s ability to unilaterally impose these changes if required by Treasury.

# \$500,000 Deduction Cap

## ★ *The Law*

- TARP participants were required to commit to abide by new section 162(m)(5) of the Internal Revenue Code which limits the annual tax deduction for remuneration of a Senior Executive Officer to \$500,000 per year. Remuneration covered by this limitation is broadly defined and includes performance-based compensation and deferred compensation.
- The Stimulus Legislation codifies this commitment so all TARP participants are subject to the \$500,000 deduction cap.
- The Treasury issued regulations on this requirement back in October, answering many questions about the mechanics for applying the limitations.

## ★ *Questions*

- Will any changes to the determination of SEOs or HCEs for purposes of the non-tax related rules (no bonus, no severance, etc.) spillover into the mechanics of applying the \$500,000 limit?

## ★ *Observations*

- No substantive change. CEO and CFO certification request reinforces need to have process in place to confirm compliance with deduction limitation.

# Luxury Expenditures

## ★ *The Law*

- A TARP Recipient’s Board must put in place a company-wide policy regarding excessive or luxury expenditures, as defined by the Treasury, which may include excessive expenditures on -
  - Entertainment or events;
  - Office and facility renovations;
  - Aviation or other transportation services; or
  - Other activities or events that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course of business operations of the TARP recipient.

## ★ *Questions*

- “Excessive” or “reasonable” in whose eyes? Senator Kerry or Representative Frank? Or customers and competitors?

## ★ *Observations*

- Expectation is that requirement to have a policy will reign in expenditures.
- Banks should expect to have to post the policy on their website and be prepared to defend it.

# Review of Prior Payments

## ★ *The Law*

- The Treasury Secretary is obligated to review bonuses, retention awards and incentive compensation paid to CEOs and the next 20 HCEs of each TARP recipient which were paid prior to February 17th to determine if any such payments were inconsistent with the purposes of the new law, the TARP or contrary to public interest.
- If Treasury determines payments to be problematic, then Treasury is to negotiate with the bank and the employee for repayment.

## ★ *Questions*

- How far back will Treasury go? Statute does not limit review to period that bank had TARP money.

## ★ *Observations*

- Negotiation required to avoid constitutional question surrounding retroactive application of limits.

# Say-on-Pay Vote

## ★ *The Law*

- TARP participants must permit a separate shareholder vote to approve the compensation of executives with disclosure pursuant to the SEC compensation disclosure rules (compensation discussion and analysis, compensation tables and related material).
- The shareholder vote is advisory only, and is not binding on the board of directors, does not overrule decisions by the board or create or imply any additional fiduciary duty by the board.
- Requirement is not limited to public companies, so private companies will be required to provide some level of compensation disclosure to shareholders in connection with annual meetings.

## ★ *Applies to this Proxy Season*

- February 26 SEC announcement confirms applicability to this year's proxy season, and 10-day preliminary filing requirement.
- Many filings have been made in the last two weeks. Most banks are taking a simple route by reflecting the statutory requirement and language without detailed explanation.

## ★ *Observations*

- Boards will not be able to ignore a “no” vote.

# Compliance Certification

## ★ *The Law*

- The CEO and CFO of a TARP participant must provide annual written certification of compliance with the requirements of the law.
- The written certification is to be filed by public companies with the SEC on Form 10-K and by private companies to the Treasury (private companies)
- Per SEC guidance, the CEO and CFO certification standards did not apply to the recently filed Form 10-Ks because regulations had not been published.

## ★ *Questions*

- Will SEC issue definitive guidance on the language of the certification, and will it include a “to the knowledge” qualifier similar to the Sarbanes-Oxley certifications currently filed by the CEO and CFO.

## ★ *Observations*

- Certification requirement mandates need to have robust TARP compliance policy and procedures.

# Special TARP Withdrawal

## ★ *The Law*

- TARP participants may repay any assistance previously received under the TARP without regard to whether the company has replaced the funds from other sources or any waiting period, subject to consultation with the appropriate Federal banking agency. When such assistance is repaid the Treasury will liquidate associated warrants at the current market price.
- TARP restrictions only apply while the preferred stock is outstanding; if Treasury retains warrants only, the bank is no longer subject to TARP restrictions
- Treasury has issued Q&A regarding the process for early repayment that clearly indicates need to coordinate with primary regulator and established minimum prepayment at 25% of the TARP amount.

## ★ *Questions*

- If a TARP recipient redeems a portion of the TARP funds, do they drop tiers for purposes of limitations?
- Is this a “one time” opportunity to repay without raising capital?

## ★ *Observations*

- Will banks that do not pay back or announce intent to pay back be considered “weak”? Compare to original regulator preference for banks to take TARP to show they were not weak.

# Webinar Schedule

- ★ Webinar #2 – Discussion of published Treasury regulations
  - One week after date of publication of regulations
  - You will be emailed of specific date when it is determined.
  - What is different from initial Stimulus Bill language?
  - What is still be to be defined in the future?
  
- ★ Webinar #3 – Discussion of market response to regulations
  - One month after Webinar #2
  - Again, you will be emailed of the specific date when it is determined.
  - How has the market reacted to published Treasury Regulations?
  - What actions are banks taking now on their compensation plans?

# Questions & Answers



# Contact Information



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