



EXECUTIVE COMPENSATION LIBRARY ON THE WEB



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Executive Compensation Restrictions In The 2009 Recovery Act

By GRETA E. COWART

The executive compensation restrictions in the American Recovery and Reinvestment Act of 2009¹ (the Recovery Act) amend some of the executive compensation provisions in the Emergency Economic Stabilization Act of 2008² (EESA), but retain the limitations on deductions for compensation paid to the chief executive officer, the chief financial officer, and the next three most highly compensated individuals of the company to \$500,000 per year when the company has sold assets to the federal government under the Troubled Asset Relief Program (TARP), but not through the direct purchase program.

The Recovery Act applies to not only future recipients of TARP funds, but also to past recipients of TARP funds for any period during which financial assistance provided under the TARP remains outstanding, excluding periods during which the Federal Government only holds warrants to purchase common stock of the TARP recipient.³

¹ Pub. L. No. 111-5.

² Pub. L. No. 110-343.

³ § 111(a)(5) of EESA as amended by § 7001 of the Recovery Act.

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Application of Restrictions Broadens From Original TARP Restrictions.

The Recovery Act restrictions on executive compensation can apply to different groups of executives. The restrictions generally apply to "Senior Executive Officers." The "Senior Executive Officers" are the top five most highly paid executives of a public company whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934 and nonpublic company counterparts.⁴ Some of the restrictions also apply to the next 10 or 20 most highly compensated employees depending on the amount of assistance the entity received from the federal government.⁵ The various restrictions and to whom each of the restrictions applies depends on the level of TARP assistance. The following restrictions apply to all levels—from less than \$25 million to \$500 million or more:

- Each TARP recipient is subject to corporate governance and executive compensation standards established by the Securities and Exchange Commission while TARP monies are outstanding.

- Compensation restrictions under I.R.C. § 162(m)(5) (\$500,000 limit) apply to the CEO, CFO, and the top three most highly compensated other officers.

- Incentive compensation is prohibited for Senior Executive Officers who take unnecessary and excessive risks that threaten the value of such recipient.

- Clawback provisions are required to recover any bonus, retention award, or incentive compensation paid to a Senior Executive Officer and any of the next 20 most highly compensated employees based on state-

⁴ § 111(a)(1) of EESA as amended by § 7001 of the Recovery Act.

⁵ § 111(b)(3)(ii) of EESA as amended by § 7001 of the Recovery Act.

ments of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.

- No golden parachute payments are permitted (defined as any payment made to a Senior Executive Officer for a departure from a company for any reason, other than for services performed).

- Any compensation plan that would encourage manipulation of the reported earnings of the TARP recipient to enhance the compensation of any of its employees is prohibited.

- Each TARP recipient must establish a board compensation committee that is comprised entirely of independent directors to review employee compensation plans and it must meet at least semi-annually for SEC registrants.⁶ It must discuss and evaluate compensation plans in light of any risk posed to the entity.

- Each TARP recipient must establish a company-wide policy regarding excessive or luxury expenditures identified by the secretary, including: 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.

The following restriction applies on a graduated scale, depending on the level of TARP assistance:

- Recipients are prohibited from paying or accruing any bonus, retention award, or incentive compensation during any period in which any financial obligation (other than a warrant to purchase common stock) is outstanding. However, this restriction does not prohibit the payment of long-term restricted stock provided such long-term restricted stock does not fully vest during the period during which any obligation from TARP financial assistance is outstanding. Provided further that the restricted stock has a value that is not greater than one-third of the total annual compensation of the employee receiving the award, and provided it is subject to other terms and conditions required by the SEC⁷

⁷ The restriction on bonus payments does not apply to any bonus payment required to be paid pursuant to a written employment contract executed on or before Feb. 11, 2009, as such valid employment contracts are determined by the secretary or the designee of the secretary.

⁶ See chart below for non-SEC registrants.

Bonus Prohibition: Level of TARP Assistance

Less than \$25,000,000	\$25,000,000 to \$249,999,999.99	\$250,000,000 to \$499,999,999.99	\$500,000,000 or more
Applies only to the most highly compensated employees of the financial institution.	Applies to at least the 5 most highly compensated employees or such higher number as the secretary may determine.	Applies to the 5 Senior Executive Officers and at least the 10 next most highly compensated employees, or such higher number as the secretary may determine.	Applies to the 5 Senior Executive Officers and at least the 20 next most highly compensated employees, or such higher number as the secretary may determine.

For non-SEC registrants, the compensation committee requirement above applies as follows:

Compensation Committee Requirements

Less than \$25,000,000	\$25,000,000 to \$249,999,999.99	\$250,000,000 to \$499,999,999.99	\$500,000,000 or more
The compensation committee functions must be fulfilled by the full board of directors. ¹ § 111(c)(1) & (3) of EESA as amended by § 7001 of the Recovery Act.	A compensation committee must be established in the same manner as for SEC registrant above. ² § 111(c)(1) of EESA as amended by § 7001 of the Recovery Act.	A compensation committee must be established in the same manner as for SEC registrant above. ³ <i>Id.</i>	A compensation committee must be established in the same manner as for SEC registrant above. ⁴ <i>Id.</i>

Determination of Which Executives are Subject to the New Requirements. The Recovery Act did not define how one determines the executives subject to the restrictions that are ranked by pay. It is not clear if the determination is made based upon 2007 compensation for 2008, or if it is based on projected compensation for the year before application of the limitations. If the limitations cause the top group to no longer constitute the top group, is the top group subject to the limitations re-determined, which would make the determination of which individuals are subject to the restriction a very circular analysis. The inability to determine which executives are subject to these restrictions causes problems for companies that are subject to § 7001 of the Recovery Act in preparing their annual reports because they cannot state their 2008 financial results and prepare their 2009 proxy statements because they do not know how the

Recovery Act executive compensation provisions are to be applied and how these impact the income statement.⁸ Some groups have questioned if the executive compensation restrictions can be effective before guidance implementing the Recovery Act provisions is issued.⁹

Say on Pay. In addition to the restrictions outlined above, the statute adds a nonbinding shareholder approval of executive compensation to any proxy or consent or authorization for an annual or other meeting of any TARP recipient for as long as the TARP assistance remains outstanding. The resolution is to approve the compensation of the executives as disclosed pursuant to the compensation disclosure rules of the SEC, including the compensation discussion and analysis, the compensation tables, and any related materials. While the SEC disclosure rules are limited to SEC registered companies, the Recovery Act does not limit the nonbinding vote provision to just those entities that are SEC registered.

The Recovery Act states that the vote is nonbinding and it may not be construed as overruling a decision by such board nor is it to be construed to create or imply additional fiduciary duty by such board. The required vote is not to be construed as restricting or limiting the ability of shareholders to make proposals for inclusion in proxy materials related to executive compensation.¹⁰ Senator Christopher J. Dodd, Chairman of the Committee on Banking, Housing and Urban Affairs, in a Feb. 20, 2009, letter to the Chairman of the Securities Exchange Commission, Mary Schapiro, indicated that in his view TARP recipients who had filed preliminary or definitive proxy statements with the Securities Exchange Commission on or before Feb. 17, 2009, should not be required to comply with the “Annual Shareholder Approval of Executive Compensation” requirement for such proxy. On Feb. 26, 2009, the SEC added to its Compliance and Disclosure Interpretations a statement that it is following the views expressed in Chairman Dodd’s letter to Chairman Schapiro.¹¹ The say on pay vote is required even if the company does not receive a shareholder request to approve the compensation of executives.¹² The say on pay requirement is not satisfied by the company merely adopting a policy providing for annual shareholder votes on executive compensation in the future. Instead, to satisfy the Recovery Act’s requirement, an actual, nonbinding vote by the shareholders to approve the executive compensation is required.¹³

The SEC clarified in its interpretations that the shareholder vote on executive compensation is only required at the annual meeting and that it is not required at any special meeting or other meeting.¹⁴ The SEC also clarified that smaller reporting companies that are not subject to the Compensation Discussion and Analysis under Item 402 of Regulation S-K are not required to provide a Compensation Discussion and Analysis just because they are subject to the “say on pay” requirement in the Recovery Act.¹⁵

CEO and CFO Certification of Compliance With Executive Compensation Provisions. The Recovery Act also required the CEO and CFO of each TARP recipient to provide a written certification of compliance by the company with the requirements related to executive compensation and corporate governance standards. Such standards have not yet been issued. Senator Dodd in his letter to the Chairman Schapiro commented, “As this certification requirement relates to compliance with executive compensation and corporate governance standards that have yet to be established by the Secretary of the Treasury, it is my view that this requirement is not yet effective and therefore CEOs and CFOs will not be required to certify as to their company’s compliance with such standards until they have been established.” The Division of Corporate Finance indicates on the SEC Web page that it is following the views of Senator Dodd’s letter, which includes the relief from the CEO and CFO certifications of compliance with the executive compensation standards.¹⁶

Application to Previously Granted TARP Funds. The SEC is to issue final rules and regulations implementing these changes within one year of enactment. The Recovery Act gives the Secretary the authority to review bonuses, retention awards, and other compensation paid to the Senior Executive Officers and the next 20 most highly compensated employees of each entity that received TARP assistance before the date of enactment to determine if any of such payments were inconsistent with the purposes of the new executive compensation rules enacted by the Recovery Act or with TARP. If the Secretary determines that any such payments are inconsistent, then the Secretary is authorized to negotiate with the TARP recipients and executives for appropriate reimbursements to the federal government.¹⁷

Differences From the Administration’s Proposal on Feb. 4, 2009. The Recovery Act did not adopt the administration’s original proposal that there be an absolute cap on total annual executive compensation, other than restricted stock, of \$500,000. However, the Recovery Act expanded the prohibition on its version of “golden parachute payments” to prohibit any payments to Senior Executive Officers, but did not adopt the administration’s proposal to also limit the next 20 officers to one times annual compensation for such “golden parachute” payments. The golden parachute payments in the Recovery Act are broader than traditional golden parachute payments made on change in control and include all payments made upon separation from employment.

⁸ See American Bankers Association letter dated Feb. 18, 2009, to Secretary of the Treasury Timothy F. Geithner.

⁹ *Id.*

¹⁰ § 111(e) of EESA as amended by § 7001 of the Recovery Act.

¹¹ Available at <http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm>.

¹² *Id.*, Q&A-4.

¹³ *Id.*, Q&A-5.

¹⁴ *Id.*, Q&A-1.

¹⁵ *Id.*, Q&A-2.

¹⁶ Available at <http://www.sec.gov/divisions/corpfin/guidance/arrainterp.htm>.

¹⁷ § 111(f) of EESA as amended by § 7001 of the Recovery Act.