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## Treasury Announces New Restrictions on TARP Executive Compensation

Responding to the public outcry over bonuses paid to executives of banks that had received government funds, on February 4, 2009, the Treasury Department announced a new set of restrictions for companies receiving “exceptional assistance.” Treasury cited AIG, and the Bank of America and Citi transactions under the Targeted Investment Program as examples of past transactions providing “exceptional assistance.” *However, the new rules are not retroactive and therefore would not apply to any of those companies unless, of course, they elect to receive additional funds which are “exceptional assistance.”* These new rules will not apply to companies participating in a generally available capital access program such as the *Capital Purchase Program (CPP)* where the same terms apply to all participants.

Treasury also announced a set of new guidelines it intends to impose on banks participating in any *new* generally available capital access program. These new guidelines will be subject to public comment, so the exact form of these new restrictions and when they would go into effect is not known. Importantly, these new restrictions will *not* apply retroactively to existing investments or to programs already announced such as the CPP and the Term Asset-Backed Securities Loan Facility.

### Companies Receiving Exceptional Assistance

**Annual Compensation of Senior Executives Must be Limited to \$500,000:** This new guidance prohibits compensation *payments*, not just deductions in a total amount exceeding \$500,000. The only exception is for restricted stock or other similar long-term incentive arrangements that can be paid only after the government has been repaid – including the contractual dividend payments – or after a specified period according to conditions that “consider among other factors the degree a company has satisfied repayment obligations, protected taxpayer interests or met lending and stability standards.” The guidelines do not address arrangements whereby executives can hedge their risk by selling derivatives or a basket of similar securities. Such an arrangement, while monetizing the interest, would

clearly be contrary to the intent of creating long term incentives.

**Executive Compensation Structure and Strategy Must be Fully Disclosed and Subject to a “Say on Pay” Shareholder Resolution:** The senior executive compensation structure and the rationale for how compensation is tied to sound risk management must be submitted to a non-binding shareholder resolution. There is no guidance given as to the consequences of failing to obtain the necessary shareholder vote nor any specifics which an institution could cite as Treasury “best practices” in its proxy materials.

**Bonuses for Top Executives Engaging in Deceptive Practices Must be Subject to Clawbacks:** Current restrictions impose clawback restrictions on the top five executives. A company receiving exceptional assistance must have in place provisions to claw back bonuses and incentive compensation from any of the next 20 senior executives 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. Significantly, the requirement of knowledge is a relaxation of the Section 111 provisions in the ESSA which require a recovery if there is a material inaccuracy in the financial results upon which executive pay is based, regardless of an absence of knowledge.

**No Golden Parachutes for Senior Executives:** The existing programs providing exceptional assistance to financial institutions prohibit the top five senior executives from receiving any golden parachute payment upon severance from employment, a ban that will be expanded to include the top 10 senior executives. In addition, the next 25 executives will be prohibited from receiving any golden parachute payment greater than one year’s compensation upon severance from employment.

**Boards of Directors Must Adopt Policies Relating to Approval of Luxury Expenditures:** Boards of directors of companies receiving exceptional assistance must adopt a company-wide policy on any expenditures related to aviation services,

office and facility renovations, entertainment and holiday parties, and conferences and events and chief executive officers will be required to certify expenditures that could be viewed as excessive or luxury items. This new policy is not intended to cover reasonable expenditures for sales conferences, staff development, reasonable performance incentives and other measures tied to a company's normal business operations. The test of reasonableness will be difficult to apply. It is doubtful that Treasury will consider lavish sales meetings and reward trips sponsored by competitors as convincing justification. The "everybody does it" excuse will have little influence in the current environment.

### Financial Institutions Participating in New Generally Available Capital Access Programs

The Treasury release states that a proposed guidance will be issued for public comment on new executive compensation requirements. More importantly, Treasury emphasizes that these new guidelines *will not apply* to existing programs. The guidance reemphasizes that the "new standards *will not apply* retroactively to existing investments or to programs already announced." This assurance has calmed the anxiety of many Troubled Asset Relief Program (TARP) participants who were fearful Treasury would attempt to tighten the standards retroactively. It also follows on the heels of announcements by several large companies which declined CPP investments after Treasury gave its approval. Clearly, there are hundreds if not thousands of applicants awaiting processing many of whom are tentative in their intentions. This assurance will calm any fears that Treasury will immediately invoke a catch 22. The less obvious consequence of these new guidelines may be the effect on Treasury's application of its review standards which to date has been less than transparent and criticized as inconsistent at best. With a new program those banks rated as a high CAMEL 3 but not 1 or 2 (a kind of regulatory Lake Woebegone where all the

banks are above average) but could be placed in TARP II with the more onerous standards applying. The standards that Treasury proposes for exceptional assistance programs (i.e. TARP II), are discussed below:

**Excessive Risk Analysis Expanded to All Employees:** The proposed guidance will expand the requirement to review and certify that the compensation arrangements for the Company's top five executives do not encourage excessive and unnecessary risk-taking to all employees.

### Senior Executives Total Annual Compensation Limited to \$500,000 Plus Restricted Stock – Unless Waived with Full Public Disclosure and Shareholder Vote:

According to Treasury, companies that participate in generally available capital access programs may "waive" the \$500,000 plus restricted stock rule only by disclosure of their compensation and, if requested, a non-binding "say on pay" shareholder resolution. Again, no guidance is offered as of yet as to the consequences of failing to obtain the necessary shareholder vote other than it is non-binding.

### Bonuses for Top Executives Engaging in Deceptive Practices Must be Subject to Clawbacks:

The same clawback provision that applies to companies receiving exceptional assistance will apply to those in generally available capital access programs. Curiously, the requirement of knowledge is included in the guidance without any discussion of imputed knowledge or explanation of the apparent inconsistency with Section 111 of ESSA. Presumably securities law concepts will be applied.

### Increased Ban on Golden Parachutes for Senior Executives:

Companies cannot pay severance pay to any of the top five senior executives upon an involuntary separation in excess of one year's compensation reduced from three years' compensation.

### Boards of Directors Must Adopt Policies Relating to Approval of Luxury Expenditures:

This policy will be the same for companies accessing generally available capital programs as it is for those receiving exceptional assistance. Luxury, a relative term, is undefined although the reference to aviation services, entertainment etc. is the same as under the exceptional assistance program standards.

### Long Term Regulatory Reform:

The Treasury release also signals future policy examination of the desirability of implementing some of the new standards for all public financial institutions. The focus of the examinations will include: disclosure strategies for aligning sound risk management and compensation; encouraging long term planning, such as share retention requirements; and say on pay resolutions. The release also indicates that a White House-Treasury sponsored summit on compensation will be scheduled in the near future. What is not clear is that if these standards are to be applied to public financial institutions whether they will apply to all public companies.

### The Unintended Consequences of These New Rules?

This proposal may mark the end of a viable assistance program for healthy banks. Most all healthy banks made subject to these standards will be more reluctant to participate in future TARP federal aid programs. Banks that do will most certainly be branded with the scarlet letter.

Banks, particularly those accepting "exceptional assistance," may find it more difficult to attract and retain senior executive talent. A White House press release states that these new guidelines "seek to strike the correct balance between the need for strict monitoring and accountability on executive pay and the need for financial institutions to fully function and attract the talent pool that will maximize the chances of financial recovery and taxpayers being paid back

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## Treasury Announces New Restrictions on TARP Executive Compensation (cont.'d)

on their investments.” It strains credulity to expect that executives given a opportunity to earn more immediately at an unregulated company would not change employers. This will cause a brain drain from those companies in which the taxpayer carries the most risk. Further, there is no discussion of the accounting consequences of issuing restricted stock in lieu of cash payments. Also, the ability to grant restricted stock will often depend on shareholder approval which may be unlikely if the dilutive effect is too great. If the company’s predicament is so negative that shareholders would gladly dilute future equity gains, management would understand the odds against the shares having any future value. Finally, the most troubling aspect of this proposal is that as skilled managers flee the regulated sector, it will foster the growth of unregulated companies, which is a principal reason for the current economic crisis. Alternatively, managers in senior positions will enter the employ of foreign institutions.

Lots of time and effort will be devoted to trying to work around these new restrictions. Executive compensation lawyers with available time since the passage of the 409A deadline on December 31, 2008, will have new projects to work on. Commentators have already begun to discuss possible loopholes such as tracking securities and methods to monetize equity incentives. However, Treasury will almost certainly impose anti-abuse provisions.

Finally, one cannot help but recall the failed past efforts of the government to regulate executive compensation. Gary Locke and Paula Todd of Towers Perrin in an October 14, 2008, article entitled *Surviving a Regulatory Storm: Executive Compensation Issues in the Current Economic Crisis*, summarized it nicely:

As is often the case, however, Congress risks doing more harm than good when it meddles with the market forces that shape executive pay. The lawmakers’ track record on pay regulation certainly hasn’t been very impressive. In fact, many critics of pay legislation have pointed to 280G and 162(m) as fueling the growth of executive pay, rather than restraining it. By defining a minimum threshold for “excess parachutes” (i.e., three times an executive’s prior pay

level), 280G undoubtedly contributed to pulling many less generous parachutes up to (or, more precisely, just below) this level. Similarly, by making stock options exempt performance-based compensation under 162(m) – along with the fact that options were then “free” from an expensing standpoint – the lawmakers helped pave the way for options to fuel much of the growth in pay in the 1990s bull market.

### About the Authors

Doug Faucette is a banking attorney in LLB&L’s corporate department and co-head of the TARP Group. Mr. Faucette has more than 30 years of experience representing publicly and privately held companies in a variety of corporate and securities transactions.

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