



FINANCIAL SERVICES ALERT

Squire, Sanders & Dempsey L.L.P.

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Economic Stimulus Act Imposes New Executive Compensation and Corporate Governance Requirements for Participants in the TARP Capital Purchase Program

On February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the "Act"). Title VII of the Act imposes significant new executive compensation restrictions and corporate governance obligations on institutions participating in the Troubled Asset Relief Program (the "TARP") Capital Purchase Program ("CPP") and other TARP participants.

The new provisions apply both prospectively to institutions that complete issuances under the CPP in the future, as well as retrospectively to institutions that have already issued securities under the CPP. Unfortunately, although key executive compensation and governance provisions in the Act appear to be effective immediately, many terms used in those provisions are ambiguous or undefined. In addition, a number of provisions, arguably, are presently effective, but remain subject to rulemaking by the Secretary of the Treasury (the "Secretary") or the Securities and Exchange Commission (the "SEC"). As a result, the executive compensation and governance provisions, as enacted, raise many significant questions and compliance issues that must be resolved.

The first part of this Alert briefly describes certain of the key restrictions and obligations under the Act. The second part of this Alert identifies a number of practical observations that CPP participants should consider with respect to these new restrictions and obligations.

Topics Include:

Executive Compensation	2
Corporate Governance	3
Elimination of Impediment to Redemption of TARP Securities	3
Some Practical Observations.....	4

Please check our [publications page](#) for additional Squire Sanders Alerts on the Economic Stimulus Act.

Executive Compensation

Title VII of the Act amends Section 111 of the Emergency Economic Stabilization Act of 2008 (the "EESA") and requires the Secretary to establish additional standards with respect to executive compensation and corporate governance. These standards must include the following:

Prohibition on "Golden Parachutes". Prohibition on making **any payment** to a senior executive officer or any of the next five most highly-compensated employees in connection with departure for **any reason** during any period when obligations under the TARP remain outstanding (the "Restricted Period"). The sole exception to this prohibition is for payments for "services performed or benefits accrued." This prohibition is very broad and arguably covers any payments under any discretionary policy or plan (such as most ordinary severance policies) or other form of award paid in connection with departure, and goes beyond the scope of the golden parachute payment limits originally imposed by the EESA.

Restrictions on Bonuses. Prohibition on **paying or accruing** any bonus, retention award or incentive compensation during the Restricted Period to certain senior executive officers and other highly-compensated employees (other than limited grants of restricted stock). The number of executive officers and/or employees to whom the prohibition on these types of payments applies varies for CPP participants from 5 to 25 based upon the dollar value of securities issued to the Treasury under the CPP.

The prohibition does not apply to the payment of long-term restricted stock with a value no greater than 1/3 of the annual compensation of the subject employee, provided the restricted stock may not fully vest during the Restricted Period. The prohibition also does not prohibit payments required pursuant to a "written employment contract" executed on or before February 11, 2009.

Clawbacks. A provision requiring the recovery by the TARP participant of any bonus, retention award or incentive compensation paid to a senior executive officer and the next 20 most highly-compensated employees of the TARP participant if the payment was based on statements of earnings, revenues, gains or other criteria that are later found to be materially inaccurate.

Review of Prior Payments; Reimbursement. The Secretary is required by the Act to review all bonuses, retention awards and other compensation paid to senior executive officers and the next 20 most highly-compensated employees paid prior to the date of enactment of the Act to determine whether such payments were inconsistent with the purposes of the Act, the TARP or otherwise contrary to public interest. If such a determination is made, the Secretary is required to negotiate with the TARP participant and subject employees for appropriate reimbursement of such compensation to the Federal Government (as opposed to the TARP participant).

Prohibition on Excessive Risk-Taking; Manipulation. Prohibits compensation that incentivizes senior executive officers of TARP participants to take "unnecessary and excessive risks", and prohibits any compensation plan that would encourage manipulation of reported earnings of the TARP participant to enhance the compensation of any of its employees. These restrictions are similar to existing prohibitions imposed on TARP participants under the Capital Purchase Program.

Corporate Governance

Key corporate governance requirements under the Act include:

Compliance Certification. The CEO and CFO of each TARP participant must provide written certification (“Officer Certifications”) of compliance with the executive compensation and governance requirements of the Act. For TARP participants with securities that are publicly traded, the Officer Certifications must be provided to the SEC, together with annual filings required under the securities laws. For TARP participants that are not publicly traded, the Officer Certifications must be provided to the Secretary.

Establishment of Compensation Committee. Each TARP participant must establish a compensation committee of its board of directors comprised entirely of independent directors and the committee must meet at least semi-annually to discuss and evaluate employee compensation plans in light of any risk posed to the TARP participant. For certain TARP participants that are not subject to the reporting requirements of the Securities Exchange Act of 1934 (the “Exchange Act”), these duties must be carried out by the full board of directors. These new standards appear to be in addition to existing requirements under the EESA with respect to compensation committee review of executive incentive compensation plans.

Limits on Luxury Expenditures. The board of directors of each TARP participant must adopt company-wide policies regarding excessive or luxury expenditures on (i) entertainment or events, (ii) office and facility renovations, (iii) aviation or transportation services, or (iv) other activities that are not considered to be reasonable expenditures for staff development, reasonable performance incentives or other similar measures conducted in the normal course of business. As with the other provisions of the Act described above, the Secretary will have the task of defining what constitutes an “excessive” or “luxury” expenditure.

Shareholder “Say-on-Pay” Requirement. During the Restricted Period, any proxy statement for an annual or other shareholder meeting of any TARP participant must permit a separate non-binding shareholder vote for approval of executive compensation. The SEC is required to issue final rules and regulations with respect to this ambiguous requirement no later than one year after the date of enactment.

Elimination of Impediment to Redemption of TARP Securities

The Act permits TARP participants to redeem securities (other than the warrants) issued under the TARP CPP (subject to consultation with the appropriate Federal banking agency), without regard to whether the no-call period has expired or whether the qualified equity offering requirement has been satisfied. Upon redemption of the securities, the Secretary will liquidate any warrants associated with such securities at the current market price.

Some Practical Observations

Many of the foregoing restrictions remain subject to further rulemaking by the Secretary or the SEC, which may significantly impact the manner in which these provisions are finally implemented and interpreted. In the meantime, past and future TARP participants may find it helpful to consider the following practical observations:

1. Many employees of TARP participants that will become subject to executive compensation restrictions (e.g., golden parachute payments, bonus payment/accrual) will not be members of the TARP participant's senior management team. TARP participants should begin to identify those employees who may be subject to the restrictions under the Act and commence a review of the elements of each such employee's compensation for compliance and employee retention purposes. Unfortunately, the Act does not define those items of compensation constituting "compensation" for purposes of determining the most highly-compensated employees. Absent other guidance, TARP participants that are subject to the Exchange Act should probably look to the standards established by the SEC under the proxy rules for determining their named executive officers.
2. TARP participants should develop a communication and action plan to avoid losing highly-compensated employees who fear becoming subject to the compensation restrictions or who misunderstand the effect of application of the restrictions on them. Competitors who are not TARP participants may try to take advantage of this fear and misunderstanding to recruit away top producers.
3. The Act does not specify the form or manner in which the Officer Certifications must be provided to the SEC (for publicly traded companies). It is also unclear whether any Officer Certifications must be provided until the Secretary has promulgated rules implementing the Act. Those TARP participants that determine to provide the Officer Certifications prior to publication of implementing regulations or other guidance may wish to consider submitting the Officer Certifications to the SEC as correspondence rather than as exhibits that are filed or furnished with the Form 10-K. In addition, given the lack of definitions in the Act for many key terms, in the absence of guidance, CEOs and CFOs of TARP participants may consider qualifying their certifications based upon their good faith belief subject to future rulemaking or interpretation.
4. Compensation committee charters should be examined, along with existing compensation policies and procedures, to determine whether any changes will be necessary.



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