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# Client Alert

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## NEW EXECUTIVE COMPENSATION RULES UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

Today, President Obama signed into law The American Recovery and Reinvestment Act of 2009 (the “Stimulus Act”). The Stimulus Act includes new rules relating to executive compensation for companies receiving assistance under the Troubled Assets Relief Program (“TARP”). The new rules apply to all financial institutions that have already received financial assistance under TARP (estimated at nearly 400 entities to date), as well as to financial institutions that receive TARP assistance in the future.

The new executive compensation rules under the Stimulus Act replace certain requirements established by the Emergency Economic Stabilization Act of 2008 (“EESA”); the tax deduction and excise tax provisions of EESA continue to apply. Further, the rules differ from the executive compensation guidelines proposed by the Obama Administration, as outlined in a February 4, 2009 press release from the Treasury Department. The Stimulus Act does not include the Administration’s proposed \$500,000 cap on certain executive

compensation. However, it does impose more stringent restrictions on financial institutions relating to the payment of bonuses. Representatives from the Obama Administration have indicated that the President may still seek changes in the executive compensation rules for TARP recipients, even though he has signed the new law.

### Executive Compensation and Corporate Governance Standards

The Stimulus Act requires that TARP recipients comply with standards relating to executive compensation and corporate governance to be established by the Secretary of the Treasury (the “Secretary”).

- *Excessive Risk Compensation* – impose limits on compensation to exclude incentives for senior executive officers (generally, the 5 most highly paid) to take unnecessary and excessive risks that threaten the value of the company.

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- *Bonuses Based on Inaccurate Results* – provide for the recovery of bonuses and incentives paid to senior executive officers and the next 20 most highly compensated employees based on materially inaccurate statements of earnings, revenues, gains or other criteria.
- *Golden Parachute Payments* – prohibit a senior executive officer or any of the next 5 most highly compensated employees from receiving a golden parachute payment, defined to include any payment for departure from a company for any reason (except payments for services performed or benefits accrued).
- *Plans Encouraging Manipulation of Earnings* – prohibit any compensation plan that would encourage manipulation of reported earnings to enhance the compensation of employees.

### **Bonus Prohibition**

The standards to be established by the Secretary will also include a prohibition on paying or accruing any bonus, retention award or incentive compensation to officers and employees, based on the amount of TARP assistance received, as described below:

- \$25 million or less, applies only to the most highly compensated employee;
- more than \$25 and less than \$250 million, applies to the 5 most highly compensated employees;
- more than \$250 and less than \$500 million, applies to senior executive officers and the 10 next most highly compensated employees;
- \$500 million or more, applies to senior executive officers and the 20 next most highly compensated employees;

- the Secretary also may apply the restrictions to a larger group of employees if it finds that it is in the public interest to do so (except as to the first category above).

*Restricted Stock Exception.* Awards of restricted stock may be excepted from these prohibitions on incentive compensation, provided that the restricted stock does not fully vest while TARP obligations are outstanding and does not have a value greater than one-third (1/3) of the employee's annual compensation.

*Written Contract Exception.* The prohibition on incentive compensation does not apply to bonus payments made pursuant to a valid written employment contract executed on or before February 11, 2009, as determined by the Secretary.

### **Board Evaluation and Officer Certifications**

A Board Compensation Committee (comprised of independent directors) of each TARP recipient must meet at least semi-annually to discuss and evaluate compensation plans in light of the risk such plans pose to the company. TARP recipients whose stock is not publicly traded and who have received \$25 million or less of TARP assistance must have the full Board of Directors perform this evaluation.

The CEO and CFO of each TARP recipient must provide an annual written certification of compliance with the provisions of the Stimulus Act, to be filed with the Securities and Exchange Commission ("SEC") or, if the company is not publicly traded, with the Secretary.

### **Luxury Expenditures**

The Board of Directors of each TARP recipient must maintain a company-wide policy regarding excessive or luxury expenditures. Such expenditures may include entertainment or events, office and facility renovations, aviation and transportation services, and other activities

or events that are not reasonable expenditures for staff development, reasonable performance incentives or similar measures in the normal course of the business.

### **Non-Binding Shareholder Vote (“Say on Pay”)**

Each publicly traded TARP recipient will be required to hold an annual shareholder approval vote on executive compensation. The vote will be provided for in any proxy or consent authorization for an annual or other meeting of shareholders held during any period the TARP assistance remains outstanding. The vote will apply to the executive compensation required to be disclosed pursuant to executive compensation disclosure rules of the SEC. This “say on pay” vote will not be binding, will not overrule any decision of the Board of Directors and will not create or imply any additional fiduciary duties on the Board. The SEC must issue any final rules required by this provision within 1 year of enactment.

### **Review of Prior Payments**

The Stimulus Act requires the Secretary to review bonuses, retention awards and other compensation of senior executive officers and the next 20 most highly compensated employees that were paid before the date of enactment of the Stimulus Act to determine whether such payments were inconsistent with the Stimulus Act, TARP or contrary to public interest. If such determination is made, then the Secretary must seek to negotiate with the company and employee for reimbursement.

### **Period of Restriction**

The Stimulus Act’s executive compensation restrictions apply for as long as any obligation arising from financial assistance provided under TARP remains outstanding. This does not include any period during which the government only holds warrants to purchase common stock of the TARP recipient. TARP

recipients may repay any assistance previously provided without regard to whether the financial institution has replaced such funds from any other source.

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A number of interpretive questions are raised by the new executive compensation rules under the Stimulus Act, and Treasury Department regulations are expected to be developed soon to implement the new law. Future legislation from Congress and other rules developed by the Administration also remain a possibility for TARP recipients. During the coming year, it is also possible that some of these restrictions, in particular the shareholder “say on pay” vote, will serve as the model for new executive compensation rules for non-TARP recipients.

Financial institutions that have received TARP funds should begin to plan for compliance with the new executive compensation rules under the Stimulus Act. Institutions that are considering applying for TARP assistance should also review these requirements carefully.

Please feel free to discuss this Client Alert with your regular Milbank contacts or with the Partners in our Executive Compensation and Employee Benefits Group, whose information is provided below.

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