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Executive Compensation Limitations & Corporate Governance Standards in Stimulus Bill

Please note that the name of the Stimulus Bill should be the "American Recovery & Reinvestment Tax Act of 2009," not "2008" as was incorrectly stated in the previous version of this Alert.

COMPENSATION STANDARDS

Title VII of the Stimulus Bill (formally known as the "American Recovery & Reinvestment Tax Act of 2009") amends section 111 of the Emergency Economic Stabilization Act of 2008, which placed limitations on compensation to senior executive officers for those institutions participating in TARP programs.^[1] According to the Stimulus Bill, the Secretary of the Department of Treasury must require each TARP recipient^[2] to meet "appropriate standards for executive compensation." These standards for senior executive officer^[3] compensation must include the following:

- **Deterrence of Unnecessary Risks.** Limits on compensation must exclude incentives to take unnecessary and excessive risks that threaten the TARP recipient's value during the period in which any obligation arising from the TARP assistance remains outstanding.
- **Clawbacks.** A provision for the recovery by the TARP recipient of any bonus, retention award, or incentive compensation paid to a senior executive officer or the next 20 most highly-compensated employees based on statements of earning, revenues, gains or other criteria later found to be materially inaccurate.
- **Golden Parachute Prohibitions.** A prohibition on any golden parachute^[4] payment to a senior executive officer or any of the next five most highly-compensated employees during the period in which any obligation arising from financial assistance provided under TARP remains outstanding.
- **Bonus Restrictions.** A prohibition on paying or accruing any bonus, retention award or incentive compensation during the period in which any obligation arising from financial assistance provided under TARP remains outstanding, except with respect to the payment of eligible long-term restricted stock.^[5] This prohibition applies to a TARP recipient's employees based on the value of financial assistance to the recipient.^[6] This prohibition does not prohibit the payment of any bonus required to be paid pursuant to a written employment contract executed on or before February 11, 2009, the validity of which is determined by the Secretary or his designee.
- **Prohibition on Manipulation.** A prohibition on any compensation plan that would encourage manipulation of the reported earnings of such TARP recipient to enhance the compensation of any of its employees.
- **Creation of Committee.** A requirement for the establishment of a Board Compensation Committee.

The CEO and CFO (or their equivalents) of each TARP recipient must provide a written certification of compliance with the above standards to the Securities and Exchange Commission (if a public company) or to the Secretary of the Treasury.

CLAWBACK OF COMPENSATION

The Secretary will review bonuses, retention awards and other compensation paid to the senior executive officers and the next 20 most highly compensated employees of each entity receiving TARP assistance before the date of enactment of the Stimulus Bill to determine whether any such payments were inconsistent with the purposes of the TARP or otherwise contrary to public interest. If the Secretary determines that any bonus or payment was inconsistent, then the Secretary will negotiate with the TARP recipient and employee for appropriate reimbursements to the federal government respecting the compensation or bonus.

PROHIBITION ON LUXURIES

The Board of Directors of any TARP recipient must have in place a company-wide policy regarding excessive or luxury expenditures, as identified by the Secretary, including 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.

"Say on Pay" SHAREHOLDER APPROVAL

TARP recipients must permit shareholders to vote at any annual or other meeting during the period in which any obligation arising from financial assistance provided remains outstanding, in order to approve the compensation of executives as disclosed according to rules issued by the Securities and Exchange Commission.^[7] This shareholder vote, however, is not binding on the Board and may not be construed as overruling a decision by such Board; nor does the vote create or imply any additional fiduciary duty by the Board.

BOARD COMPENSATION COMMITTEE

Except as otherwise excluded, every TARP recipient must establish a Board Compensation Committee comprised entirely of independent directors for the purpose of reviewing compensation plans. In the case of a TARP recipient that has not registered common or preferred stock and that received \$25 Million or less in financial assistance, the Board of Directors will carry out the Committee's responsibilities. The Committee must meet at least semiannually to discuss and evaluate these plans in light of any risk posed to the recipient from such plans.

WITHDRAWAL FROM TARP PROGRAM

Subject to consultation with the appropriate federal banking agency,^[8] if any, the Secretary must permit a TARP recipient to repay any assistance previously provided under TARP without regard to whether the financial institution has replaced such funds from any other source or to any waiting period. Once the recipient repays the financial assistance, the Secretary must liquidate warrants associated with the assistance at the current market price.

LEGISLATION STRICTER ON COMPENSATION THAN TREASURY PROPOSAL

The compensation requirements as adopted by Congress in the Stimulus Bill reflect a not-so-subtle rebuke of Secretary Timothy Geithner's proposed compensation limitations. Notwithstanding Treasury's announced vision for reining in CEO compensation, Congress adopted two major changes that:

- **Expand the Scope of Restrictions.** The Stimulus Bill applies the executive compensation standards to any company that has received TARP money or will receive TARP money. In contrast, Treasury's plan would have applied the standards only to future TARP recipients.
- **Remove The Cap on Overall Compensation but Restrict Bonuses.** As noted above, the Stimulus Bill restricts bonus awards to long-term restricted stock that cannot exceed one third of an executive's annual cash compensation and that is subject to vesting limits and other conditions while TARP financial assistance remains outstanding. In contrast, Treasury's plan would have capped overall compensation at \$500,000.

The White House and other commenters were critical of these modifications from Treasury's proposed plan, noting that the new provisions would only incent companies to pay their executives higher base salaries to justify the stock bonuses and may drive talent from banks before they return to profitability.

^[1] 12 U.S.C. § 5221. Section 111 of EESA placed compensation limitations on the top five highly paid executives of a public company, and non-public company counterparts. The limitations included: (A) limits on compensation that exclude incentives for senior executive officers of a financial institution to take unnecessary and excessive risks that threaten the value of the financial institution; (B) a provision for the recovery by the financial institution of any bonus or incentive compensation paid based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate; and (C) a prohibition on the financial institution making any golden parachute payment to its senior executive officers during the period that the Secretary holds an equity or debt position in the financial institution.

^[2] A "TARP recipient" is defined as "any entity that has received or will receive financial assistance under the financial assistance provided under the TARP." Note that the Secretary is not required to apply executive compensation restrictions solely in connection with loan modifications undertaken under Section 109 of EESA.

^[3] "Senior Executive Officer" is "an individual who is one of 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 any regulations issued thereunder, and non-public company counterparts."

^[4] A "Golden Parachute Payment" is "any payment to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued."

^[5] To qualify as long-term restricted stock, the stock must not fully vest during the period in which any obligation arising from financial assistance provided to the TARP recipient remains outstanding; have a value in an amount that is not greater than one-third of the total

amount of annual compensation of the employee receiving the stock; and be subject to such other terms and conditions as the Secretary of the Treasury may determine is in the public interest.

[6]

If the recipient received financial assistance equal to or less than \$25 Million, the prohibition applies only to the most highly compensated employee; if the recipient received at least \$25 Million but less than \$250 Million, the prohibition applies to at least the five most highly compensated employees or such higher number as the Secretary determines; if the recipient received at least \$250 Million but less than \$500 Million, the prohibition applies to the senior executive officers and at least the next 10 most highly compensated employees or such higher number as the Secretary determines; if the recipient received \$500 Million or more, the prohibition applies to the senior executive officers and at least the 20 next most highly compensated employees, or such higher number as the Secretary determines.

[7]

The SEC must issue these regulations within one year after date of enactment of the Stimulus Bill.

[8]

The term "appropriate Federal banking agency" means--

- (1) the Comptroller of the Currency, in the case of any national banking association, or any Federal branch or agency of a foreign bank;
- (2) the Board of Governors of the Federal Reserve System, in the case of--
 - (A) any State member insured bank,
 - (B) any branch or agency of a foreign bank with respect to any provision of the Federal Reserve Act which is made applicable under the International Banking Act of 1978,
 - (C) any foreign bank which does not operate an insured branch,
 - (D) any agency or commercial lending company other than a Federal agency,
 - (E) supervisory or regulatory proceedings arising from the authority given to the Board of Governors under section 7(c)(1) of the International Banking Act of 1978, including such proceedings under the Financial Institutions Supervisory Act of 1966, and
 - (F) any bank holding company and any subsidiary of a bank holding company (other than a bank);
- (3) the Federal Deposit Insurance Corporation in the case of a State nonmember insured bank, or a foreign bank having an insured branch; and
- (4) the Director of the Office of Thrift Supervision in the case of any savings association or any savings and loan holding company.

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