

TANSTAAFL: EXECUTIVE COMPENSATION AND THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009

Wednesday, February 4, 2009

On February 17, President Obama signed into law the \$787 billion America Recovery and Reinvestment Act of 2009. The Act is a veritable cornucopia of financial tools and fiscal stimulae which are designed to promote economic recovery within the private and governmental sectors. It includes many tax breaks for businesses, new incentives for tax-exempt financing by financial institutions, expanded financing tools for local governmental entities, energy tax incentives, and provisions affecting transportation and infrastructure. The Act also modifies and expands upon the executive compensation standards that were originally issued under the Troubled Assets Relief Program ("TARP") in the Emergency Economic Stabilization Act of 2008 ("EESA"), as well as the measures previously announced by the Treasury on February 4, 2009.

This article will focus solely on the incentive compensation provisions of the Act, or "TANSTAAFL" as I like to call them.

I believe it was the science fiction writer, Robert Heinlein, who first popularized the acronym "TANSTAAFL" in his 1966 novel, "The Moon is a Harsh Mistress" (which, ironically, discusses the problems caused by not considering the eventual outcome of an unbalanced economy). TANSTAAFL (or for those of you who are more grammatically inclined, "TINSTAAFL") is an acronym for the adage "There Ain't No Such Thing As A Free Lunch" and, as we will discover in the summary below, there certainly is no such thing as a free lunch when it comes to the

receipt of any government largesse under the TARP.

Summary of the Executive Compensation Provisions

In reviewing this summary, you should be aware that the executive compensation provisions of the Act are more stringent than the limits previously announced by the Treasury on February 4, 2009 in the following significant respects:

- **The executive compensation limits apply retroactively to all institutions that have already received funds under the TARP;**
- **Certain of the executive compensation limits apply to more than the top five most highly paid executives and**
- **Treasury may retroactively review compensation payments to confirm that such payments were consistent with the TARP and not contrary to the "public interest."**

As long as any TARP obligation (excluding government warrants to purchase common stock) is outstanding, institutions must comply with the following incentive compensation provisions:

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- **Risk Avoidance.** Incentive compensation must be structured to avoid incentives for the senior executive officers to take unnecessary and excessive risks
- **Bonus Clawback.** Institute “claw-back provisions” to recover any bonus, retention award or incentive compensation paid to the senior executive officers and any of the next 20 most highly-compensated employees based on materially inaccurate financial or other information.
- **Golden Parachutes.** Prohibit “golden parachute payments” upon severance from employment for senior executive officers and the next five most highly-compensated employees.
- **Earnings Manipulation.** Prohibit compensation plans that encourage manipulation of earnings to enhance the compensation of any employees.
- **Restricted Stock Bonus.** Certain employees may only receive a bonus, retention award or incentive compensation in the form of restricted stock that (i) does not fully vest during the period in which TARP obligations are outstanding, (ii) has a value no greater than one-third of the employee’s annual compensation and (iii) is subject to any other terms and conditions the Treasury may determine. This prohibition generally does not apply to any

bonus payments required pursuant to a written employment contract executed on or before February 11, 2009. The applicability of this restriction, which depends upon the amount of TARP obligations outstanding, extends to the following employees:

- The most highly-compensated employee of an institution receiving less than \$25 million,
- At least the top five most highly-compensated employees (or such higher number as the Secretary of the Treasury determines to be in the public interest) of an institution receiving at least \$25 million but less than \$250 million under the TARP,
- The senior executive officers and at least the ten next most highly-compensated employees (or such higher number as the Secretary of the Treasury determines to be in the public interest) of an institution receiving at least \$250 million and but less than \$500 million, and
- The senior executive officers and at least the 20 next most highly-compensated employees (or such higher number as the Secretary of the Treasury determines to be in the public interest) of an institution receiving \$500 million or more.
- All TARP recipients continue to be subject to existing IRS restrictions which generally limit the deductibility of

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compensation paid to the senior executive officers to \$500,000 per year.

- Notably, the Act does not define “highly compensated employee.”
- **Certification.** The chief executive officer and chief financial officer must certify to the SEC (or Treasury, if not publicly traded) that their institution has complied with all executive compensation restrictions.
- **Compensation Committee.** Institutions must establish a compensation committee (comprised solely of independent directors) which meets at least semiannually to discuss and evaluate compensation plans and assess any risk posed by such plans. In the case of privately-held institutions receiving \$25 million or less, such duties may be undertaken by the board of directors.
- **Luxury Expenditures.** The board of directors must adopt a company-wide policy regarding excessive or luxury expenditures, as determined by Treasury, regarding expenditures on entertainment or events, office and facility renovations, aviation or other transportation services, or other activities or events that are not reasonable expenditures conducted in the normal course of the business.
- **Shareholder Advisory Vote.** Shareholders are entitled to approve the compensation of executives, as disclosed pursuant to SEC compensation disclosure rules. The shareholder vote is non-binding. The SEC is required to implement rules regarding this requirement within one year of the date of enactment.
- **Retroactive Review.** Treasury will review all prior bonuses, retention awards, and other compensation of senior executive officers and the next 20 most highly-compensated employees to determine whether such payments were inconsistent with the purposes of EESA or TARP or were contrary to the public interest. Any such payments which are deemed to be inconsistent or contrary are subject to reimbursement to the government.
- **Repayment.** An institution may repay TARP assistance regardless of whether it has replaced such funds from other sources. Treasury will liquidate any warrants associated with such assistance at their current market price.