

# Aldrich Bonnefin & Moore, PLC

## NAVIGATING THROUGH EXECUTIVE COMPENSATION RULES UNDER TARP

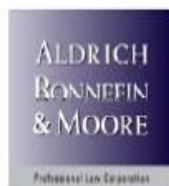
When the Troubled Assets Repurchase Program, also known as TARP, was first announced in October 2008, it was seen by financial institutions as much needed relief. Since then, as a result of mounting public anger about Wall Street bailouts, Congress and Treasury have added layers of executive compensation restrictions for TARP recipients, first with the passage of the American Recovery and Reinvestment Act of 2009 (ARRA), and then with Treasury's implementation of ARRA through executive compensation and corporate governance rules codified in 31 CFR Part 30 (the "Compensation Regulations"). Treasury issued the Compensation Regulations in June 2009, after many institutions already signed up for TARP (mostly under the Capital Purchase Program). The breadth and complexity of the Compensation Regulations came as a surprise to many.

The Compensation Regulations are divided into several components, namely (1) prohibiting certain compensation practices, (2) requiring compensation committees to review compensation plans and certifying compliance with the Compensation Regulations, (3) requiring the disclosure of certain perquisites and compensation consultants, and (4) mandating the establishment and disclosure of an excessive or luxury expenditure policy. This article focuses on the most complex and prohibitive restrictions on certain compensation practices.

### Bonus Restrictions

Perhaps the most commonly discussed aspect of the Compensation Regulations is the prohibition against "bonus" payments to certain bank employees. The Compensation Regulations define "bonus" very broadly, including any payment or right to payment in addition to amounts payable for services performed on a periodic (for example, bi-weekly) basis. There is no minimum threshold, meaning that even nominal payments are potentially included. The prohibition against bonus payments offers three principal exemptions, which each must satisfy specific criteria: commission compensation, long-term restricted stock, and bonus payments to which the employee had a contractual right as of February 11, 2009.

For many community banks, however, the impact is limited because the prohibition only applies to the institution's most highly compensated employee (for those receiving less than \$25 million in financial assistance) or the five most highly compensated employees (for those receiving between \$25 million and \$250 million).



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The difficult task is often in identifying who is covered. The Compensation Regulations do not distinguish between executive officers and “line” employees, or even between commission compensation, regular salary and other benefits for the purpose of determining who are the “most highly compensated.” This leads to sometimes surprising results of having high-performing commissioned employees being subject to the prohibition, while the CEO continues receiving bonuses. Also, the identity of the most highly compensated employees is subject to change on a yearly basis, meaning that different people could be covered in different years.

Finally, while the term “bonus” first triggers thoughts of year-end cash payments, the characterization can find itself in many forms of compensation. For example, accelerations of vesting under executive retirement plans and many forms of deferred benefits could be considered a “bonus” under the Compensation Regulations.

### **Prohibition Against Golden Parachutes**

The second main restriction under the Compensation Regulations is the prohibition against so-called “golden parachute” payments. A golden parachute payment includes any form of compensation or benefit that is payable by virtue of a person’s departure, for any reason (including change in control or involuntary termination) other than death or disability. It excludes the payment for services performed or benefits already accrued. For example, severance payments and acceleration of vesting upon a change in control are all “golden parachute payments.”

Regardless of the TARP recipient’s level of financial assistance, the restriction applies to the institution’s “Senior Executive Officers,” or “SEOs,” and the next five most highly compensated employees. Referring to SEC rules, the regulations define an SEO as the institution’s CEO, CFO, and next three most highly compensated employees.

As change in control and other termination benefits are common provisions of executive compensation agreements, many institutions will find such provisions to violate the Compensation Regulations.

### **Clawback**

A less discussed requirement of the Compensation Regulations is the requirement that the institution’s SEOs and next twenty most highly compensated employees return to the TARP recipient any compensation that is based on materially inaccurate financial statements.

While most institutions will never have to demand a return for compensation under this rule, its larger scope of covered employees and inherent risk for conflict makes it particularly important to have covered employees execute clawback agreements, consistent with the Compensation Regulations. Treasury has required most TARP recipients to only have their five SEOs execute general compensation waivers, but not the next twenty most highly compensated employees subject to the clawback requirement, so institutions should fill that gap by having all affected employees sign a clawback agreement in accordance with the Compensation Regulations.

## **Other Restrictions**

The Compensation Regulations also impose a number of lesser known restrictions and limitations on TARP recipients. These include:

- Disclosure for “perquisites” exceeding \$25,000.
- Prohibition against tax “gross-ups.”
- Disclosure of compensation consultants.
- A “say-on-pay” rule requiring a non-binding shareholder vote on executive compensation practices (only applies to publicly traded institutions).
- Establishment of a compensation committee responsible for periodic reviews of compensation practices and certification requirements.
- Adopting excessive or luxury expenditures policy.

## **Future Changes**

In informal discussions, Treasury has indicated that they are actively working on a revised and final rule, although they provided no timeline for the issuance for such rule. The final rule is expected clarify many of the currently vague or unclear provisions of the current rule and address some of the feedback received by Treasury under the current rule.