**New Limits Imposed on Executive Pay by Economic Stimulus Law;
Retroactive Review of Excessive Bonuses Mandated**

Companies that have received or that will receive benefits under October 2008's Emergency Economic Stabilization Act will be subject to significant new limits on executive pay. Under the new American Recovery and Reinvestment Act of 2009 (enacted February 17, 2009), all companies receiving benefits under the October law's Troubled Asset Relief Program (or TARP) will be subject to uniform pay controls, regardless of which TARP sub-program the benefits are provide under.

In addition, the Treasury Department must review all bonuses, retention awards and other compensation paid to senior executives (described below) and the next 20 most highly-compensated employees of each company that received TARP assistance prior to February 12, 2009, to determine if any of such payments were inconsistent with the purposes of the new pay controls or are otherwise contrary to the public interest. If so, Treasury will seek to negotiate with the TARP company and the offending employee for appropriate reimbursements.

The new controls, which remain in effect for as long as TARP assistance remains outstanding (excluding Treasury's holding of warrants), require each TARP company to:

- <u>Limit Incentives for Unnecessary and Excessive Risks</u>: Consistent with the prior TARP controls, the TARP company must limit senior executive pay that "encourages unnecessary and excessive risks that threaten the value of the institution." The five senior executives subject to these rules remain the institution's Chief Executive Officer, Chief Financial Officer, and next three highest paid officers as determined under applicable SEC rules.

- <u>Prohibit Bonuses</u>. A new control prevents participating TARP companies from paying or accruing any bonus, retention award or incentive compensation, except for restricted stock with an aggregate value of less than one-third of the employee's total compensation and which does not fully vest while Treasury has a stake in the institution. This control applies to executives ranging from the most highly compensated employee (for financial institutions receiving less than $25,000,000) to the five senior executives plus at least the 20 next most highly-compensated employees (for institutions that receive over $500,000,000). This control does not apply to payments under written employment contracts executed on or before February 11, 2009. As under the TARP, any compensation plans that encourage manipulation of reported earnings of the TARP recipient that would enhance employee compensation are prohibited under the ARRA.

- <u>Prohibit Golden Parachutes</u>. A TARP company may not pay golden parachutes to its senior executives or any of the next 5 most highly-compensated employees. A "golden parachute" for this purpose means any payment for departure from the company for *any reason*, except for payments for services performed or benefits accrued. This definition is significantly broader than the TARP definition (limited to payments in the nature of compensation made on account of involuntary termination or in connection with a bankruptcy filing, insolvency or receivership), and the new prohibition applies to a broader universe of executives.

- Install Clawback Provisions. A TARP company must be able to recover any bonus, retention award or incentive compensation paid to any of the five senior executives or any of the next 20 most highly-compensated employees if based on criteria later proven to be materially inaccurate. Under the original TARP controls, this rule applied only to the five senior executives.

- Forgo Compensation Deductions in Excess of $500,000. Consistent with the prior TARP controls, a TARP company will be denied a deduction for any compensation, including deferred compensation, paid to a senior executive in any year over $500,000. (The limit for public companies that do not participate remains $1,000,000.) Institutions still may not avail themselves of the performance-based compensation exception (or other exceptions under prior law), with the result that stock options and bonus payments will be subject to this limit. Further, if a senior executive is or becomes subject to the reduced limit during any year, that executive will remain subject to the limitation for all subsequent years while these controls apply. In addition, for deferred compensation, the limit continues even after Treasury has been paid back (until the deferred compensation is fully paid).

- Establishment of Compensation Committee. Each TARP company must now establish a Compensation Committee, comprised entirely of independent directors, which will meet semiannually and will review all employee compensation plans. For institutions that are not registered with the SEC and who have received $25,000,000 or less in TARP assistance, these duties must be undertaken by the full board.

- Certification of Compliance. Each TARP company's Chief Executive Officer and Chief Financial Officer must provide the SEC with a written certification of compliance with the ARRA controls with its annual filings if publicly traded, or to the Secretary of the Treasury if not publicly traded. Under the previous TARP rules, only the Compensation Committee was required to certify that it had completed the requisite reviews of senior executive pay.

- Limitation on Luxury Expenditures. A TARP company must adopt company-wide policies regarding "excessive or luxury expenditures," which may include spending limitations on entertainment or events, office and facility renovations, aviation or other transportation services or other activities that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures in the normal course of business.

- Shareholder Approval. Any proxy or consent or authorization for an annual meeting or any other shareholder meeting of any TARP company must permit a separate shareholder vote to approve executive compensation. Such shareholder vote will be non-binding on the TARP recipient's board of directors and may not overrule a decision by such board. This "say on pay" provision did not exist under the TARP.

- Permission to Repay. If a TARP company desires to rid itself of the ARRA controls, Treasury will permit the institution to repay the funds received under the TARP, regardless of whether the funds have been replaced with another funding source or whether any waiting periods have expired. When repaid, Treasury will liquidate any warrants at the current market price.

If you have any questions relating to this Client Update please contact your primary attorney at Morrison Cohen LLP or any of the following:

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