GROOM LAW GROUP

MEMORANDUM TO CLIENTS

February 13, 2009

RE: Executive Compensation Rules in Stimulus Bill and Treasury Guidance

Congress is expected to pass later today, and shortly thereafter the President is expected to sign into law, the economic stimulus package (the "Act"). The Act modifies the executive compensation restrictions that apply to financial institutions participating in the troubled asset relief program ("TARP") created as part of the financial bailout legislation enacted last fall. Among other things, the Act contains limits on the incentive compensation and severance that may be paid to executives at TARP recipients and the amounts that TARP recipients may deduct related to executive pay. Importantly, the Act restrictions will apply to all past and future TARP recipients.

The Act comes on the heels of new TARP executive compensation restrictions announced by the Obama Administration on February 4th. Below is a summary of the notable restrictions in the Act and those imposed by the Obama Administration.

While both sets of rules only apply to TARP recipients, there is considerable concern that future legislation may apply some of these restrictions to companies not accepting TARP funds. As discussed below, the Administration plans to look into executive compensation reforms for all financial institutions, not just those receiving TARP funds. And key Congressmen have expressed interest in applying some of these rules more broadly.

I. Restrictions in Stimulus Bill

Summarized below are the key restrictions in the Act. Treasury is also authorized to provide additional restrictions. Generally, these rules apply until a TARP recipient repays the government the amounts received.

Bonus Restriction. The Act creates a general prohibition against the payment or accrual of "any bonus, retention award, or incentive compensation" for certain senior executives. This bonus restriction applies to a certain number of the company's highest paid employees that varies from 1 – 25 (subject to an upward adjustment by Treasury) depending on the level of assistance the company received. The bonus restriction contains an exception for "long-term" restricted stock if

- the stock does not fully vest before Treasury is paid back,
- the value of the restricted stock does not exceed 1/3 of the executive's annual compensation, and

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- the stock is subject to any other terms and conditions Treasury determines "is in the public interest."

Severance Prohibition. TARP recipients may not pay any severance to its SEOs (generally top-5 highest paid executives whose compensation is required to be disclosed under the SEC's proxy rules and their counterparts in non-public companies) or any of the next five highest-paid employees.

$500,000 Deduction Limit. The modified Code section 162(m) $500,000 annual limit on deductible compensation under earlier TARP rules applies to all recipients of TARP funds.

"Say on Pay." The Act requires public company TARP recipients to include in their annual proxy statement a non-binding shareholder vote on the compensation of the institution's executives. The Act instructs the SEC to issue final rules implementing this provision within one year of enactment.

Policy on Luxury Expenditures. The Act directs the board of directors for a TARP recipient to adopt a company-wide policy regarding "excessive or luxury expenditures" as identified by Treasury. This policy may include excessive expenditures on

- entertainment or events,
- office and facility renovations,
- aviation or other transportation service, or
- other activities and events that are "not reasonable expenditures for staff development, reasonable performance incentives, or other similar measures conducted in the normal course" of business operations.

Treasury Review of Amounts Already Paid. The Act directs Treasury to review the bonuses, retention awards, and other compensation paid prior to the date of enactment to SEOs and the next 20 highest paid employees of TARP recipients. Treasury is to determine whether any of these payments were inconsistent with (i) the Act's executive compensation restrictions, (ii) TARP, or (iii) were otherwise contrary to the public interest, and then to enter negotiations with the institution for the federal government to be repaid the inappropriate amounts.

Excessive Risk. There are to be rules on arrangements that cause SEOs to take unnecessary and excessive risks that threaten the value of the institution.

Clawback. TARP recipients must be able to recover any bonus or incentive compensation paid to an SEO and any of the next 20 highest-paid employees based on financial statements that are later proven to be materially inaccurate (i.e., a "clawback" provision).

No Incentive For Manipulation. There are to be rules providing for prohibitions on the company maintaining any compensation plan that would encourage manipulation of the company's earnings to enhance any employee's compensation.

CEO and CFO Certification. The CEO and CFO of a TARP recipient are to provide certification of compliance with these executive compensation restrictions to either the SEC (if publicly traded) or Treasury (if not publicly traded).

Board Compensation Committee. TARP recipients will need to have a Board Compensation Committee, comprised of independent directors, which meets at least semiannually to discuss and evaluate employee compensation plans in light of any risk posed to the institution from such compensation.

II. Restrictions Announced by Obama Administration

Earlier, on February 4, the White House and Treasury Department issued a press release announcing new restrictions on executive compensation for financial institutions receiving assistance under the TARP program. Except for certain new certification requirements, the press release distinguishes between institutions receiving "exceptional assistance" (e.g., the bank-specific negotiated agreements with AIG, Bank of America and Citigroup) and those participating in a "generally available" program, and provides that the new restrictions will not apply retroactively to existing investments or to previously announced programs (e.g., the Capital Purchase Program).

Many of these new restrictions track those contained in the Act, but some go further – most notably by generally limiting SEO annual pay to $500,000, except for certain long-term incentive arrangements. The press release did not announce how these new restrictions relate to the TARP guidance previously issued by Treasury, and it is unclear the extent to which these restrictions may be revised in future, more formal guidance in light of the passage of the restrictions in the Act.

SEO Compensation Limited to $500,000. The total annual compensation of SEOs of a company receiving exceptional assistance is limited to $500,000, except for restricted stock or other similar long-term incentive arrangements under which vesting cannot occur until after the government has been repaid or after a specified period that takes into account certain factors (e.g., the degree the institution has met repayment obligations, protected taxpayer interests or met lending and stability standards). Companies participating in a generally available program could waive the $500,000 limit by disclosing their compensation and, if requested, submitting the compensation to a non-binding "say on pay" shareholder resolution.

The Act does not contain a similar total annual compensation limit. The Senate version did contain an annual limit of $400,000 (based on the President's annual pay).

Expanded Golden Parachute Restrictions. In the case of companies receiving exceptional assistance, the top 10 senior executives (not just the top-5 SEOs) are prohibited from receiving any golden parachute payment upon severance from employment, and the next 25 executives are prohibited from receiving a golden parachute payment upon severance from employment greater than one year's compensation. In the case of companies in a generally available program, the SEOs are prohibited from receiving any golden parachute payment upon severance from employment greater than one year's compensation.

"Say on Pay." A company receiving exceptional assistance is required to submit its senior executive compensation structure, and the rationale for how compensation is tied to sound risk management, to a non-binding shareholder resolution. All companies participating in a future capital access program are required to disclose the reasons that the compensation arrangements of both senior executives and other employees do not encourage excessive and unnecessary risk taking.

Policy on Luxury Expenditures. As under the Act, a policy must be adopted on "luxury expenditures." CEOs are required to certify expenditures that could be viewed as excessive or luxury items, and the luxury policy must be posted on the company's web site.

Clawback. Companies receiving exceptional assistance or participating in a generally available program are required to "clawback" bonuses and incentive compensation from the top 25 executives (not just the top-5 SEOs) if they are found to have knowingly engaged in providing inaccurate information relating to financial statements or performance metrics on which the compensation is based.

CEO Certification. The CEO of any company that has already received or that will in the future receive any form of government assistance under the TARP must annually certify that the company has strictly complied with all statutory, Treasury Department, and contractual restrictions. The compensation committee for all companies receiving TARP assistance must provide an explanation of how their senior executive compensation arrangements do not encourage excessive and unnecessary risk taking.

Long-Term Regulatory Reform. The press release also provides that the Obama Administration plans to engage in long-term efforts to examine how company-wide compensation structures at financial institutions encouraged excessive risk-taking that contributed to the financial crisis and to develop model compensation policies, including:

- requiring the compensation committees of all public financial institutions (not just those receiving assistance) to review and disclose strategies for aligning compensation with sound risk-management and long-term value creation for the company and its shareholders;

- requiring top executives at financial institutions to hold equity compensation for several years after it is awarded to encourage a longer-term focus on the economic interests of the institution;

- requiring all financial institutions to submit to shareholders a non-binding resolution on both the levels of executive compensation and how the structure of compensation incentives promote risk management and long-term value creation; and

- hosting a White House-Treasury conference with shareholder advocates, major public pension and institutional investors, policy-makers, executives, academics, and others on long-term executive pay reform and best practices at financial institutions.

Although the Administration's press release states that these efforts will be focused on the compensation structures of financial institutions, it is likely that any long-term efforts in this area could result in changes that would apply to all companies, not just financial institutions.

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Please call one of the following, or the Groom attorney you regularly contact, if you have any questions about this or any other matter.

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