

MEMORANDUM TO CLIENTS

June 12, 2009

RE: Treasury Announces Executive Compensation Rules for TARP Recipients and Proposed Legislation for All Public Companies

On June 10th, Treasury released an Interim Final Rule providing guidance on the executive compensation and corporate governance provisions in the Emergency Economic Stabilization Act of 2008 ("EESA"), as amended by the American Recovery and Reinvestment Act of 2009 ("ARRA") (collectively, the "Act"). Since the enactment of EESA in October of 2008, both Congress and the Obama Administration have provided piecemeal guidance on the executive compensation restrictions that apply to companies participating in the troubled asset relief program ("TARP").

The Interim Final Rule (the "Rule") consolidates and supersedes the prior executive compensation guidance and adopts additional standards. Generally, the provisions of this Rule are effective immediately upon publication in the Federal Register (scheduled for June 15th), and to the extent previous contractual provisions are not inconsistent, such provisions shall remain effective and continue to apply to TARP recipients. For example, TARP recipients that agreed not to claim a deduction for compensation during a taxable year in excess of \$500,000 for certain executive officers shall continue to be required to forego such deduction.

On the same day that the Rule was released, Treasury announced that it will pursue two pieces of executive compensation legislation that would apply to all public companies. We summarize below the key provisions in the Rule and the proposed legislation.

I. Executive Compensation Rules for TARP Recipients

Summarized below are the key executive compensation restrictions in the Rule. Generally, these restrictions apply until a TARP recipient repays the government the amounts received (the "TARP Period"). The TARP Period will not include the period when the government holds only warrants to purchase stock. Importantly, Treasury dropped its proposed \$500,000 annual limit on pay other than restricted stock.

Determination of Executives Subject to Restrictions. Many of the executive compensation restrictions in the Rule are limited to senior executive officers ("SEOs") and/or a certain number of other "most highly compensated employees." For this purpose, a public company's SEOs each year are those officers whose compensation for the prior year is disclosed in the company's proxy statement (i.e., the top five). A company's "most highly compensated employees" other than the SEOs are determined in the same manner as the determination of which highly paid executive officers' compensation is disclosed in the proxy. Thus, the employees' total compensation for the prior year (as determined under the SEC's summary compensation table rules) is the basis for this determination. Private companies need to use

analogous rules to determine their executives subject to the restrictions. Employees need not be officers to be covered by the rules and employees of entities that are 50% or more owned by a TARP recipient may be covered by the rules.

In the preamble to the Rule, Treasury addressed an issue many have identified whereby an executive subject to the Act's restrictions in one year may have reduced total compensation for that year and, thus, not be in the top paid group for the following year. Rather than providing rules to address this situation, Treasury asks for comments on how to address the issue.

Bonus Restriction. The Act created 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 depending on the level of assistance the company received.

The bonus restriction in the Act contained an exemption for certain "long-term restricted stock." The Act also provided a controversial exemption for amounts paid under a written contract executed on or before February 11, 2009. The Rule provides voluminous details on this bonus prohibition and these two key exemptions. We summarize these rules below.

A. *Impermissible Bonus Accruals and Payments*

The Rule provides guidance, including the following, on what types of accruals and payments to the covered executives are or are not permissible:

- Certain types of commissions are permitted.
- Benefits under qualified retirement and other broad-based plans are permitted.
- Benefits under a nonqualified deferred compensation plan generally should be permitted.
- Equity awards, including options and SARs, are generally prohibited incentive compensation.
- Amounts payable on completion of a transaction are prohibited incentive compensation.
- Forgiveness of a loan may be a prohibited bonus.

The Rule provides guidance on determining when prohibited bonuses are treated as accruing for this purpose and an anti-abuse rule to prevent make-ups to covered executives who miss out on bonuses.

B. *Permissible Restricted Stock and RSU Awards*

The Rule makes clear that the exemption in the Act for "long-term restricted stock" also applies to restricted stock units ("RSUs"). The following restrictions are imposed on these permissible grants of restricted stock and RSUs:

- The value of the annual grant to a covered executive is limited to 1/3 of the executive's total compensation in the year of grant. Total compensation for this purpose will be determined using a modified version of the SEC's definition for purposes of the summary compensation table.
- A grant must be forfeited if the executive terminates within two years of the grant date other than due to death, disability, or a change in control.
- Restricted shares may become transferable, and RSUs may be paid, in 25% increments as the TARP recipient repays the government 25%, 50%, 75% and then 100% of the financial assistance received.

C. *Grandfathered Bonus Amounts*

The Rule fleshes out the controversial exemption for contracts in place on or before February 11, 2009. Generally, if an executive had a legally binding right (as determined under the Code section 409A rules) to an amount on this date, the amount will be exempt from the bonus restriction. Examples in the Rule indicate that equity grants made before February 12, 2009 should be exempt.

Severance Prohibition. The Rule prohibits a TARP recipient from making a "golden parachute payment" to a CEO or any of the next five highest-paid employees during the TARP period. Subject to certain limited exceptions, the Act provided that a golden parachute payment includes any payment for departure from a TARP recipient other than for services performed or benefits accrued. The Rule also treats payments due upon a change in control of the TARP recipient as golden parachute payments.

For this purpose, a golden parachute payment includes the value of any accelerated vesting due to a departure or change of control. And the present value of all payments is treated as paid on the date of departure or change in control – regardless of when such amounts are actually payable. As a result, TARP recipients may not avoid this restriction by deferring payment of such amounts until after the end of the TARP period. The Rule clarifies that payments from qualified retirement plans, payments due to death or disability, and certain deferred compensation plan payments will not be treated as golden parachute payments.

In a related development, recent IRS Notice 2009-49 takes the position that Treasury's taking ownership of sufficient stock to cause a "change in control" of a TARP recipient nevertheless will not be treated as such for Code section 409A purposes. Thus, it would not be a permissible payment event under a company's 409A plans.

Clawback. TARP recipients must be able to recover any bonus or incentive compensation paid to an CEO and any of the next 20 highest-paid employees based on financial statements or performance metrics that are later proven to be materially inaccurate (i.e., a "clawback" provision). A material inaccuracy will result as to any employee who knowingly provides inaccurate information or fails to timely correct such information. In other situations, all the facts and circumstances will need to be examined. This right to recover such amounts

must be exercised by the TARP recipient unless it can show that it would be unreasonable to do so.

"Say on Pay" Requirement. The Act and the Rule require public company TARP recipients to include in any proxy statement issued during the TARP period, a non-binding shareholder vote on the compensation of its executives. The Act instructs the SEC to issue final rules implementing this provision within one year of enactment, and the Rule requires TARP recipients to comply with any SEC guidance on this issue.

Policy on Luxury Expenditures. The Act and the Rule direct the board of directors for a TARP recipient to adopt a company-wide policy regarding "excessive or luxury expenditures" as identified by Treasury. The Rule mandates the content of the policy, which must be filed with the Treasury and its primary regulatory agency and posted on the company's internet website (if one is maintained). Among other things, the policy must list prohibited categories of expenditures and the approval process for others.

Compensation Committee Review of Plans. TARP recipients will need to have a 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. The committee must identify and limit risks created by features of such arrangements that might threaten the value of the TARP recipient. The committee must also review every six months whether any features of its plans encourage the manipulation of earnings and eliminate such features. Annually, the compensation committee must provide a written narrative of how it limited problematic features in its compensation plans and certify that it has completed its required reviews of these arrangements. Certain private companies may delegate the duties of such committee to the board of directors.

Compliance Reporting. The Rule provides a specific compliance reporting regime relating to the executive compensation requirements set forth in the Rule. The lynchpin of this regime is a certification made by the CEO and CFO of a TARP recipient. The CEO and CFO are to provide certification of compliance with these executive compensation restrictions to the SEC and Treasury (if publicly traded) or to Treasury and the primary regulating agency (if not publicly traded). The annual certification will address compliance with a large number of specific requirements under the Rule.

Treasury Review of Amounts Already Paid. ARRA directed Treasury to review the bonuses, retention awards, and other compensation paid before February 17, 2009, to CEOs 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. The Special Master (discussed below) will have responsibility for reviewing these payments.

II. Additional Prohibitions, Policies and Procedures for TARP Recipients

Pursuant to the Act, Treasury is authorized to establish additional executive compensation and corporate governance standards. Treasury announced four additional standards described below in the Rule.

Prohibition on Tax Gross-Ups. A TARP recipient may not provide tax gross-ups or other reimbursements for the payment of taxes to any of the CEOs and the next 20 most highly compensated employees relating to severance payments, perquisites, or any other form of compensation. Excluded from this prohibition are certain international tax equalization arrangements.

Special Master and Advisory Opinions. The Rule establishes an Office of the Special Master (the "Special Master") for TARP Executive Compensation (the "Office") and outlines specific responsibilities that Treasury has delegated to the Special Master. The Special Master and the Office are generally relevant only to TARP recipients that receive exceptional financial assistance under TARP (seven companies at present). However, any TARP recipient or employee of a TARP recipient may request an advisory opinion from the Special Master as to whether a compensation structure or payments are inconsistent with the purposes of EESA or TARP, or otherwise contrary to the public interest. In addition, the Special Master has the authority to issue advisory opinions as to whether a compensation structure or payment meets this standard without being requested to do so by a TARP recipient or TARP recipient employee.

TARP recipients that receive exceptional financial assistance must submit for approval by the Office, with limited exceptions, (i) the compensation payments and compensation structures of the CEO and the most highly compensated employees subject to the bonus payment limitation, and, (ii) the compensation structures of all other executive officers and 100 most highly compensated employees.

Perquisite Disclosure. A TARP recipient must disclose to Treasury and its primary federal regulator annually any perquisites whose total value exceeds \$25,000 for any employee who is subject to the limitations on bonus payments. The amount and nature of the perquisites must be identified and justification for offering the perquisite must be included.

Compensation Consultant Disclosure. A TARP recipient must disclose to Treasury and its primary federal regulator annually whether the TARP recipient, the board of directors, or the compensation committee has engaged a compensation consultant and all types of services the consultant has provided in the past three years, including any benchmarking services used to establish compensation levels.

III. Proposed Legislation for All Public Companies

On the same day that it released the Rule, Treasury announced a preliminary set of broad-based principles for executive compensation. It also announced that it will seek to pass legislation applying to all public companies in the following two areas:

Say on Pay. Companies would have to provide shareholders with an annual non-binding vote on the compensation for the company's "top five" executives disclosed in the proxy.

Shareholders would also have the opportunity to cast a non-binding vote on golden parachute compensation disclosed in a proxy related to a merger or acquisition.

Compensation Committee Independence. In addition to the independence requirements of the major exchanges, compensation committee members would need to meet independence requirements similar to those for audit committee members under the Sarbanes-Oxley Act. Compensation committees would also have to be given authority and funding to retain their own compensation consultants, outside counsel and other advisors as they determine appropriate. Finally, the SEC would be required to establish independence requirements for compensation consultants and outside counsel retained by a compensation committee.

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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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