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Stimulus Act Imposes Corporate Governance and Compensation Mandates

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Introduction

The American Recovery and Reinvestment Act of 2009 (H.R. 1), as reported out of the conference committee, imposes various governance and executive compensation mandates on companies participating in the troubled assets relief program (TARP). Added by Senate Banking Committee Chair Christopher Dodd, the provisions fall under Title VII of the Act.

Among other reforms, the Act applies strong executive compensation restrictions to all recipients of TARP funds, regardless of whether they receive a capital injection or sell troubled assets at auction. The Act also requires each TARP recipient to include in its annual proxy statement a nonbinding shareholder advisory vote on the company's executive cash compensation program. The Act further prohibits golden parachutes to senior executives. It imposes strong corporate governance mandates on TARP companies, including a requirement to have an independent compensation committee. In addition, it rescinds a controversial IRS ruling on acquisitions by financial institutions.

The Act also prohibits any compensation plan that creates incentives for employees to manipulate reported earnings or take unnecessary and excessive risks that threaten the company's value. It further requires the board to adopt a company-wide policy on luxury expenditures. In addition, the Act bans bonuses for many highly-paid executives of TARP-recipient firms under a sliding scale regime based on the amount of financial assistance the TARP recipient received.

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The Act defines “senior executive officer” to mean an individual who is one of the top five most highly-paid executives of a public company and whose compensation must be disclosed pursuant to SEC executive compensation rules. Under SEC rules, these are the principal executive officer, the principal financial officer, and the company’s other three most highly-compensated executives.

The Act defines “TARP recipient” to mean any entity that has received or will receive financial assistance provided under TARP. The Act’s restrictions apply during the period when the TARP recipient has outstanding obligations arising from financial assistance provided under TARP. The Act states that the period in which any obligation arising from financial assistance provided under TARP remains outstanding does not include any period during which the federal government only holds warrants to purchase common stock of the TARP recipient.

Say on Pay

During the period in which any obligation arising from TARP assistance remains outstanding, any proxy or consent or authorization for an annual or other meeting of the shareholders of any TARP company must permit a separate shareholder vote to approve the compensation of executives, as disclosed pursuant to SEC rules (which disclosure must include the compensation discussion and analysis, the compensation tables, and any related material). Within one year of enactment, the SEC must issue final rules and regulations required by this section.

The shareholder vote will be nonbinding. Moreover, the Act provides that the vote may not be construed as overruling a decision by the company’s board or as creating any additional fiduciary duty of the board. Similarly, the advisory vote cannot be construed to restrict shareholders from making proposals for inclusion in proxy materials related to executive compensation.

Compensation Committee

As a matter of sound governance, the Act requires that each TARP company have a compensation committee composed entirely of independent directors. The compensation committee must discuss and evaluate, at least semiannually, the employee compensation plans and their potential risk to the company’s financial health.

In the case of any TARP recipient, the common or preferred stock of which is not registered under the Securities Exchange Act of 1934, and that has received $25,000,000 or less of TARP assistance, the duties of the compensation committee must be carried out by the board of directors.

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Retroactive Compensation Review

The Act also requires a retroactive review of bonuses, retention awards, and other compensation already paid out by companies that received TARP funds. Under this provision, Treasury must review bonus and retention awards and other compensation paid to executives of TARP recipients to determine whether any payments were inconsistent with the Emergency Economic Stabilization Act or TARP or otherwise contrary to public interest. If they are, Treasury must negotiate with the recipient and the subject employee for appropriate reimbursement of the compensation or bonuses to the federal government.

Repayment of TARP Funds and Loan Modifications

The Act provides that, after consulting with the appropriate federal banking agency, Treasury must permit a TARP recipient to repay any assistance previously provided under the TARP without regard to whether the financial institution has replaced such funds from any other source or to any waiting period, and when such assistance is repaid, Treasury must liquidate warrants associated with such assistance at the current market price. Treasury is ordered to adopt regulations implementing the repayment program.

The Act also provides that Treasury must not be required to apply these executive compensation restrictions, or to receive warrants or debt instruments, solely in connection with any loan modification under the Emergency Economic Stabilization Act.

Governance and Compensation Standards

During the period in which any obligation arising from financial assistance provided under TARP remains outstanding, each TARP recipient will be subject to the corporate governance and executive compensation standards established by Treasury under the Act and the provisions of Internal Revenue Code Section 162(m)(5).

Tracking SEC executive compensation disclosure rules, the five executive officers covered by Section 162(m)(5) are the chief executive officer, the chief financial officer, and the three highest-compensated officers other than the CEO or CFO. For the purpose of determining the three officers, "compensation" is defined as it is in the SEC rules to mean total compensation, whether or not it is includible in the officer's gross income. However, unlike the SEC rules that determine the highest three officers by reference to total compensation for the last completed fiscal year, the measurement period under Section 162(m)(5) for purposes of determining the three officers for an applicable taxable year is that taxable year.

For purposes of Section 162(m)(5), including the determination of whether the aggregate amount of assets acquired from an employer exceeds $300 million, two or more persons who are treated as a single employer under Section 414(b) (employees of a controlled

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group of corporations) and Section 414(c) (employees of partnerships, proprietorships, etc., that are under common control) are treated as a single employer.

An “applicable employer” for Section 162(m)(5) purposes is not limited to a publicly-traded corporation or even to the corporate business form. Thus, an entity, whether or not publicly-traded, is an applicable employer if it sells troubled assets pursuant to the Treasury’s program. Also, unlike the general 162(m) calculation of employee remuneration subject to the deductible limit, 162(m)(5) remuneration includes commissions and performance-based compensation.

Under the Act, Treasury must require each TARP recipient to meet detailed, appropriate standards for executive compensation and corporate governance. These standards must include limits on compensation that exclude incentives for senior executive officers to take unnecessary and excessive risks that threaten the value of the company during the period that any obligation arising from TARP assistance is outstanding. The standards must also include a clawback provision for the recovery of any bonus, retention award, or incentive compensation paid to a senior executive officer and any of the next 20 most highly-compensated employees of the TARP company based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate.

There must also be a prohibition of any compensation plan that would encourage manipulation of the reported earnings of a TARP recipient to enhance the compensation of any of its employees.

Further, the corporate governance standards must include a prohibition of any golden parachute payment to a senior executive officer or any of the next five most highly-compensated employees during the period that any obligation arising from TARP assistance is outstanding. The Act defines “golden parachute” to mean any payment to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued.

The Act also requires TARP recipients to establish a compensation committee of the board of directors composed entirely of independent directors for the purpose of reviewing compensation plans. The Act directs the compensation committee of each TARP recipient to meet at least semiannually to discuss and evaluate employee compensation plans in light of an assessment of any risk posed to the TARP recipient from such plans.

Another required corporate governance standard for TARP recipients is that they are prohibited from paying or accruing any bonus, retention award or incentive compensation during the period in which any obligation arising from financial assistance provided under the TARP remains outstanding. This prohibition does not, however, apply to the payment of long-term restricted stock by the TARP recipient, provided that such long-term restricted stock does not fully vest during the period in which any obligation arising from financial assistance provided to the TARP recipient remains outstanding and has a value that does not exceed one-third of the total amount of annual compensation of the

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employee receiving the stock; and also is subject to any other conditions Treasury may impose in the public interest. The prohibition on the paying of bonuses by TARP companies will apply as follows:

- For financial institutions that received TARP financial assistance of *$25,000,000 or less*, the prohibition will apply only to the company's most highly-compensated employee.
- For financial institutions that received TARP financial assistance of *between $25,000,000 and $250,000,000*, the prohibition will apply to the five most highly-compensated employees, or such higher number as Treasury determines is in the public interest.
- For financial institutions that received TARP assistance of *between $250,000,000 and $500,000,000*, the prohibition will apply to the senior executive officers and at least the next ten most highly-compensated employees, or such higher number as Treasury determines is in the public interest.
- For any financial institution receiving TARP assistance of *$500,000,000 or more*, the prohibition will apply to the senior executive officers and at least the 20 next most highly-compensated employees, or such higher number as Treasury determines is in the public interest.

The Act also provides, however, that the bonus prohibitions will not be applied to prohibit any bonus payment required to be paid pursuant to a written employment contract entered into on or before February 11, 2009, as such valid employment contracts are determined by Treasury.

The TARP company CEO and CFO must provide a written certification of compliance by the company with the executive compensation and corporate governance requirements. In the case of a TARP company whose securities are publicly-traded, the certification must be provided to the SEC, together with annual filings required under the securities laws. For nonpublic companies, the certification must be filed with the Treasury.

Luxury Expenditures

The board of directors of any TARP recipient must implement a company-wide policy regarding excessive or luxury expenditures, as identified by Treasury. These may include excessive expenditures on:

- Entertainment or events;
- Office and facility renovations;
- Aviation or other transportation services; or
- Other activities or events that are not reasonable expenditures for conferences, staff development, reasonable performance incentives, or other similar measures conducted in the normal course of business operations.

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Acquisition Losses

The Act prospectively repeals IRS Notice 2008-83 that interprets Section 382 of the Internal Revenue Code to allow banks and other financial institutions pursuing acquisitions to write off acquired losses stemming from takeovers of other banks to offset future income. Notice 2008-83 came under intense criticism by many in Congress.

Congress enacted Section 382 to prevent tax-motivated acquisitions of loss corporations. On September 30, 2008, Notice 2008-83 effectively removed the limit on the taxable income a purchasing bank, thrift, industrial loan company or trust company could deduct post-acquisition. The Notice was designed to help the struggling banking sector recover by allowing acquiring banks to deduct the built-in tax losses of any banks they acquire that have a loan portfolio that has diminished in value.

The Act states that Congress finds that the delegation of authority to the Treasury under Section 382(m) does not authorize the Secretary to provide exemptions or special rules that are restricted to particular industries or classes of taxpayers. Also, the statute says that IRS Notice 2008-83 conflicts with the congressional intent of Section 382(m) and that the legal authority to prescribe 2008-83 is doubtful.

With two exceptions, the provision states that Notice 2008-83 will not have any effect for any ownership changes after January 16, 2009. One exception is for ownership changes pursuant to a binding contract executed on or before that date. The second exception is for changes pursuant to an agreement that was executed on or before that date and was described in a public announcement or in an SEC filing.

Senator Charles Grassley, Ranking Member of the Finance Committee, has noted that Section 382 was not enacted lightly by Congress, but rather after extensive scholarly reflection by the staffs of the Senate and House tax-writing committees and the Joint Committee on Taxation. It has been an established part of the law since 1986. In the senator's view, Notice 2008-83 changed this law. He observed that many tax law scholars have opined that Treasury simply did not have authority to make this change. One of the country's largest law firms at one point estimated that this IRS waiver could cost the U.S. Treasury $140 billion in taxes that would have otherwise been paid. Further, the senator was troubled that this notice came out September 30, 2008, the day after the House voted down the first bailout bill and two days before Wells Fargo acquired Wachovia.

In a letter to Treasury and the IRS, Senator Charles Schumer demanded to know why the IRS issued a notice allowing financial institutions pursuing acquisitions to write off acquired losses stemming from takeovers of other banks to offset future income. Sen. Schumer questioned the need for the tax change after the implementation of the Treasury's capital injection program. He expressed concern that the change would result in tens of billions of lost tax dollars for the federal government, which has already committed $700 billion to many of these same financial institutions under the rescue plan approved by Congress.

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The Act also amends Section 382 to provide a special rule for ownership changes. Under that rule, the limitations contained in Section 382(a) will not apply to an ownership change pursuant to a restructuring plan that is required under a loan agreement or a commitment for a line of credit entered into with the Treasury under the Emergency Economic Stabilization Act and is intended to result in a rationalization of the costs, capitalization, and capacity with respect to the manufacturing workforce. ❐

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About the Author

James Hamilton is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation, at http://jimhamiltonblog.blogspot.com). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules*, is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.

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