

Executive Compensation Rules for the TARP Capital Program

On October 20, 2008, the Department of the Treasury (“Treasury”) released an interim final rule describing the executive compensation provisions that will govern all financial institutions that participate in the TARP Capital Program. The provisions generally apply as long as the Treasury holds an equity or debt position, including warrants and the common stock underlying the warrants, in a participating institution. To be eligible to participate in TARP Capital, financial institutions must meet the following standards:



- certify that incentive compensation for senior executive officers (“SEO”) does not encourage unnecessary and excessive risks that would threaten the value of the institution;
- require that SEO bonus and incentive compensation be subject to “clawback” if the payment was based on materially inaccurate financial statements or performance metrics;
- prohibit any golden parachute payment to an SEO; and
- agree to deduct no more than \$500,000 for an SEO’s compensation.

Subject to further clarification and guidance from the Treasury, our preliminary analysis of TARP Capital’s executive compensation rules follows:

Determination of Senior Executive Officers. The TARP Capital executive compensation rules apply only to the SEOs of a participating institution. The SEOs are (1) the principal executive officer (i.e., the CEO or equivalent), (2) the principal financial officer (i.e., the CFO or equivalent), and (3) the three other most highly compensated executive officers. An executive officer is the president, any vice president in charge of a principal business unit, division, or function (such as sales, administration, or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions. Further, officers of subsidiaries may be deemed executive officers if they perform such policy-making functions for the participating institution.

Compensation, for purposes of identifying SEOs, is determined based on the officer’s total compensation, regardless of whether the officer actually includes the amount in gross income for tax purposes. This is comparable to the regulations used to determine “named executive officers” for SEC reporting companies; however, it is uncertain exactly how those regulations, which deal primarily with disclosure requirements, apply in the TARP Capital context. For example, the SEC regulations indicate that a company does not have to disclose information on executive officers whose compensation was less than \$100,000, but the TARP Capital rules do not make clear whether this limitation applies to its provisions. Until current year compensation data is available, the rules provide that participating institutions must use their best efforts to identify their SEOs.

The TARP Capital rules currently do not definitively state whether more than five persons can be CEOs for participating institutions. This is an open question because the rules do not indicate whether only the CEO and CFO of a holding company are considered CEOs or whether the CEO and CFO of each subsidiary, if different, should also be considered CEOs. We expect this to be clarified and believe the number of CEOs will be five.

Avoid Unnecessary and Excessive Risk. Within ninety days after receiving TARP Capital, a participating institution's compensation committee (or equivalent body) and the senior risk officers must review CEO incentive compensation arrangements to ensure that the arrangements do not encourage unnecessary and excessive risk-taking that could threaten the value of the institution. Subsequently, the compensation committee and risk officers must meet at least annually to discuss and review risk-management policies and CEO incentive compensation arrangements.

The initial meeting and the subsequent meetings should address the unique nature and material risks, both short term and long term, that could threaten the value of the particular institution. Any features of an incentive compensation arrangement that could lead CEOs to take material risks should be limited. After each meeting, the committee must certify that it has reviewed CEO incentives in accordance with TARP Capital's requirements. Public institutions must place the certification in the CD&A section under Item 402(b); private institutions must place the certification in a report to the institution's primary federal regulator. TARP Capital provides a model statement that satisfies the certification standard.

Because this risk-assessment provision relies on self-policing, CEOs, compensation committees, and risk officers should all carefully follow TARP Capital's provisions regarding review and certification, and should probably have a written plan in place designed to meet the requirements of these provisions. This is especially important for public institutions because the CD&A certification will likely be subject to all Exchange Act liability provisions, including all CEO and CFO certifications in the institution's annual 10-K report.

Clawback Requirement. Under TARP Capital, a financial institution must subject all CEO bonus and incentive compensation to recovery or "clawback" if a payment was based on materially inaccurate financial statements or other performance metric criteria. TARP Capital's clawback provision is broader than a similar provision in Sarbanes-Oxley in that the TARP Capital (1) applies to all CEOs, (2) reaches both public and private institutions, (3) is seemingly triggered by any material inaccuracy in relevant material, (4) does not limit the recovery period, and (5) covers inaccuracies not only in financial reports but also in any other performance metrics used to award bonuses and incentive compensation. Participating institutions may need to amend their executive compensation arrangements and enter into special agreements with their CEOs to comply with these new clawback requirements.

Prohibiting Golden Parachutes. TARP Capital prohibits an institution from making any golden parachute payment to an CEO. Generally, a golden parachute payment refers to any payment, excluding payments from a tax-qualified retirement plan, (1) made to an CEO on account of an applicable severance (see below) and (2) that equals or exceeds three times the CEO's average total compensation during the preceding five years. Further, a golden parachute payment includes any payment that would not have been payable absent an applicable severance, including amounts that would have otherwise been forfeited and amounts that were accelerated due to the severance.

An applicable severance includes any involuntary termination or any severance resulting from a bankruptcy filing, insolvency, or receivership of the financial institution. TARP Capital specifically defines “involuntary termination” to include:

- a unilateral decision by the institution to terminate an SEO’s employment where the SEO was willing and able to continue performance;
- failure by the institution to renew an SEO’s employment contract at the contract’s expiration where the SEO was willing and able to continue performing on similar terms;
- voluntary termination by an SEO if the termination is due to a material negative change, amounting to “good reason,” in the SEO’s employment relationship; and
- voluntary termination where the facts and circumstances indicate that, absent the voluntary termination, an institution would have involuntarily terminated an SEO’s employment.

TARP Capital’s golden parachute provisions are broader than the concepts under the existing golden parachutes rules. For example, the TARP Capital’s golden parachute provisions apply to involuntary and constructive terminations whether or not a change in control has occurred and what is considered a parachute payment is more broadly defined. Therefore, participating institutions should review all severance agreements and appropriate amendments should be evaluated.

Limiting Compensation Deductions. Under the TARP Capital rules, an institution must agree to a \$500,000 annual tax-deduction cap for each SEO’s total annual compensation, including commissions and performance-based payments. This only limits the amount of the deduction that an institution may claim and not the actual amount that an institution may pay an SEO. The Treasury has designed the annual tax-deduction limitation to prevent institutions from attempting to circumvent the cap by deferring payment until TARP Capital’s provisions no longer apply. Broadly, this means that the cap for one year may preclude any deduction for deferred compensation paid in a future year if the deferred compensation is attributable to the earlier limitation year.

Control Group. TARP Capital’s rules borrow from the Internal Revenue Code and apply not only to a participating financial institution but also to any other entity within the institution’s parent-subsidary controlled group, using an 80% ownership basis to determine control.

Acquisitions. Special rules govern acquisitions, mergers, and reorganizations such that an acquiring institution does not become subject to TARP Capital solely through the acquisition of an institution that is subject to TARP Capital. Nonetheless, with respect to an acquired institution, any person who was an SEO prior to the acquisition remains subject to the executive compensation rules until after the first anniversary following the acquisition.

Modifications. As a condition to closing the purchase of the TARP Capital, the institution and the SEOs must have modified all benefit plans, arrangements, and agreements to comply with executive compensation rules under TARP Capital, including a waiver of any potential claims against the Treasury due to any modifications.

Timing. Even though the TARP period is set to expire on December 31, 2009 and can be extended to October 3, 2010, TARP Capital's rules continue to bind participating institutions for as long as the Treasury holds an equity or debt position in the institution. By the terms of TARP Capital, a participating institution may not redeem preferred shares issued to the Treasury within three years of issuance unless the institution raises at least 25% of the issuance price in a qualified offering. Moreover, a participating institution must issue warrants to the Treasury, and the Treasury may hold the warrants for up to ten years and the common stock underlying the warrants for an indeterminate period. Thus, participating institutions may find themselves governed by TARP Capital's executive compensation rules for a significant length of time.

Recommendation. In view of these implications, institutions seeking to participate in TARP Capital should consider amendments that (1) appropriately modify benefit agreements, (2) by their own terms, expire when the Treasury no longer holds a debt or equity position, and (3) reinstate the original terms of the benefit agreements upon expiration of the amendments.

Seek Advice. TARP Capital's executive compensation rules not only incorporate tax code provisions, securities regulation issues, and best corporate governance standards but also create, at times, vague and novel legal requirements. Given this complexity, financial institutions looking to participate in TARP Capital should seek further legal advice on how best to ensure their compliance with the rules.

We will continue to review new rules and guidance as they become available. Please feel free to contact us with any questions or concerns that you may have.

More Information. The Treasury's initial press releases regarding TARP Capital and the executive compensation rules can be found at the following links:

For TARP Capital: <http://www.treas.gov/press/releases/hp1207.htm>

For TARP Capital's executive compensation rules: <http://www.treas.gov/press/releases/2008101495019994.htm>

Please also visit www.bankpogo.com for the latest information on TARP Capital.

For information on topics covered in this alert, please contact your regular Powell Goldstein contact, or any of the following attorneys:

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