

CORPORATE AND SECURITIES LAW

Alert

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New Developments in Financial Institutions and Executive Compensation: The Treasury Releases Interim Final Rule on TARP Standards for Compensation and Corporate Governance

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On Wednesday, June 10, 2009, the U.S. Treasury Department (“Treasury”) issued an Interim Final Rule (the “IFR”) implementing the executive compensation and corporate governance provisions of the Emergency Economic Stabilization Act of 2008 (“EESA”), as amended by the American Recovery and Reinvestment Act of 2009 (“ARRA”).

The IFR applies to entities that have received or hold a commitment to receive financial assistance under the Troubled Asset Relief Program (“TARP”), although there are exemptions from certain provisions for TARP recipients that do not have outstanding obligations to the government. In addition, the IFR would apply to any entity with under \$500 million in total assets that participates in the expanded TARP Capital Purchase Program for these smaller financial institutions. This expanded program increases the amount of assistance available to these institutions from 3% of total risk-weighted assets to 5%, and reopens the application period for these institutions until November 21, 2009. The IFR became effective on June 15, 2009. It will remain subject to public comment for 60 days beginning on that date, and supersedes, as of June 15, 2009, all previous inconsistent guidance applicable to a TARP recipient.

Following are some of the provisions of the IFR:

- **Generally prohibits bonuses, retention awards and incentive compensation to certain highly compensated employees**

TARP recipients are prohibited from paying or accruing any bonus, retention award (including a “make-whole” new hire award), or incentive compensation (including grants pursuant to an equity plan even if they are not subject to performance-based vesting, such as time-based stock options) to certain employees during the period that the TARP recipient has obligations outstanding. This provision applies to a varying number of employees depending on the amount of financial assistance received by a TARP recipient. For example, the prohibition on paying any bonus, retention award, or incentive compensation would only apply to the single most highly compensated employee of a TARP recipient receiving less than \$25 million in financial assistance, and would apply to the five most highly compensated employees of a TARP recipient receiving at least \$25 million but less than \$250 million in financial assistance. The

restrictions apply to a greater number of employees of TARP recipients receiving higher amounts of assistance.

There are two exceptions to this general prohibition. First, the TARP recipient may grant long-term restricted stock (or restricted stock units) provided the total annual grant value is limited to 1/3 of the employee's total annual compensation in the year of grant. In addition, the long-term restricted stock must contain certain provisions, including that the award not fully vest until the government has been fully repaid and that the employee provide at least two years post-grant service to the TARP recipient. Second, any TARP recipient may pay a bonus, retention award, or incentive compensation payment, required to be paid under a valid written employment contract, executed on or before February 11, 2009, that gives the employee a legally binding right to such payment. With respect to this second exception, it should be noted that an employee does not hold a legally binding right to payment to the extent that such payment may be reduced unilaterally, or eliminated altogether, by the TARP recipient after the services creating the right to the payment have been performed – essentially an exercise of negative discretion on the part of the TARP recipient.

In addition, the IFR contains broad anti-abuse provisions that forbid, among other things: (1) granting stock options or salary increases in lieu of bonuses that could not be accrued; (2) delaying payments until an employee is no longer subject to the prohibition; and (3) granting retroactive service credits after the employee is no longer subject to the prohibition.

- **Prohibits any severance or change of control payment to the CEOs and five next highly compensated employees**

TARP recipients are prohibited from making golden parachute payments to the principal executive officer, principal financial officer, and the three most highly compensated executive officers other than these individuals as determined by SEC rules (together, the “CEOs”), or any of the next five most highly compensated employees during the period that the TARP recipient has obligations outstanding. A golden parachute payment includes any payment (including any acceleration of vesting) for termination of employment from a TARP recipient for any reason other than death or disability, or other than any payment for services performed or benefits accrued. The IFR clarifies that any amount due upon a change in control event of a TARP recipient (regardless of whether the officer departs from the TARP recipient) is a golden parachute payment, eliminating the ability to avoid the restriction on golden parachute payments by utilizing single trigger or constructive termination upon change of control provisions. Amounts are treated as paid at the time of departure or change in control event, regardless of when actually paid, eliminating any ability to defer payment and avoid the restriction.

- **Mandates clawback provisions for the CEOs and the next 20 most highly compensated employees and requires clawback provisions be exercised unless unreasonable under the circumstances**

The IFR requires that any bonus, retention award, or incentive compensation paid or accrued to a CEO or one of the next 20 most highly compensated employees during the period that a TARP recipient has obligations outstanding be subject to a provision for recovery or “clawback” by the TARP recipient if the payments or accruals were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria. For these purposes, a financial statement or performance metric is automatically treated as materially inaccurate with respect to any employee who knowingly engaged in

providing inaccurate information relating to the financial statement or performance metric. The IFR also requires that the TARP recipient actually exercise its clawback rights, except under circumstances where such enforcement would be unreasonable, for example if the enforcement expense would exceed the recovery.

- **Clarifies and expands risk analysis and certification requirements**

The IFR requires TARP recipients to establish a compensation committee composed of independent members of the board of directors (whose independence is determined pursuant to Item 407(a) of Regulation S-K), but TARP recipients that do not have securities registered with the SEC pursuant to federal securities laws, and have received \$25,000,000 or less in financial assistance, may have the board of directors perform the duties required of the compensation committee under the IFR. To the extent not already in place, existing TARP recipients must establish an independent compensation committee by September 14, 2009. The IFR specifies that at least every six months the compensation committee must: (1) discuss, evaluate and review with the senior risk officers the CEO compensation plans to ensure that they do not encourage CEOs to take unnecessary and excessive risks that could threaten the value of the TARP recipient, including that they do not encourage behavior focused on short-term results rather than long-term value creation; (2) discuss, evaluate and review with the senior risk officers employee compensation plans in light of the risks posed to the TARP recipient by such plans and how to limit such risks, including discouraging behavior focused on short-term results rather than long-term value creation; and (3) discuss, evaluate and review employee compensation plans to ensure that these plans do not encourage the manipulation of reported earnings to enhance compensation. The compensation committee must annually provide a plan-by-plan narrative description of its review and how it eliminated prohibited features of its CEO and employee compensation plans as outlined above and annually certify that it has completed the reviews of such plans. Such disclosures and certifications are required to be filed with the SEC and the Treasury, or if the TARP recipient is not public, with its primary regulatory agency and the Treasury.

- **Requires an excessive or luxury expenditure policy**

The board of directors of TARP recipients must adopt an excessive or luxury expenditure policy, file this policy with Treasury and the recipient's primary regulatory agency, and post the text of this policy on its website, if applicable, by September 14, 2009, for existing TARP recipients. The IFR sets forth a general framework and the requirements that such policies must contain, but the TARP recipient itself determines what are "excessive or luxury expenditures" and establishes a set of specific requirements to make this determination.

As guidance in making this determination, the Treasury has defined the term "excessive or luxury expenditures" to include any: (1) entertainment or events; (2) office or facility renovations; (3) aviation or other transportation services; or (4) any other similar items or events for which the TARP recipient anticipates incurring expenses, that are not reasonable for staff development, performance incentives or other similar expenditures incurred in the normal course business.

Within the policy preventing excessive or luxurious expenditures, TARP recipients are to: (1) identify the types or categories of expenditures which are prohibited; (2) identify the types or categories of expenditures for which prior approval is required; (3) provide procedures for obtaining prior approval; (4) require the principal executive officer and the principal financial officer to certify prior approval

procedures were properly conducted; (5) require prompt reporting of violations; and (6) mandate adherence to the policy.

- **Institutes “Say on Pay”**

TARP recipients are required to permit a nonbinding shareholder vote on executive compensation in compliance with SEC rules, regulations and guidance. The IFR does not specifically address whether this “Say on Pay” requirement is intended to apply to companies that do not file annual proxy materials with the SEC. We expect that this question will be clarified by Treasury following the public comment period.

- **Mandates additional perquisite disclosure**

Going beyond what was previously required, the IFR requires that TARP recipients must disclose annually to Treasury and their primary federal regulatory agency any perquisite whose total value exceeds \$25,000 for any employee who is subject to the limitations on bonus payments. TARP recipients are required to identify the amount, nature and recipients of the perquisites and disclose a justification for offering these perquisites.

- **Requires certain disclosures regarding compensation consultants**

Another new rule found in the IFR is the requirement that the compensation committee of TARP recipients (or the board of directors of the TARP recipient if not required to maintain a compensation committee) must disclose annually to Treasury and their primary federal regulatory agency whether the TARP recipient, the board, or the compensation committee has engaged a compensation consultant. They must describe the types of services the compensation consultant or any of its affiliates has provided to the TARP recipient, the board, or the compensation committee during the past three years, including any “benchmarking” or comparisons employed to identify certain percentile levels of compensation. This narrative disclosure should identify the entities included in the benchmarking and include a justification for using these entities and the lowest percentile level proposed for compensation.

- **Restricts tax gross-ups**

The IFR also introduces a new rule regarding tax gross-ups. TARP recipients are prohibited from providing tax gross-ups or other reimbursements for the payment of taxes relating to any severance payment, perquisite, or other form of compensation to any of the CEOs or the next 20 most highly compensated employees.

- **Implements additional requirements for TARP recipients receiving exceptional financial assistance**

TARP recipients receiving exceptional financial assistance (generally defined as any financial assistance beyond the Capital Purchase Program) must submit for approval by the Office of the Special Master the compensation payments and compensation structures of the CEOs and the most highly compensated employees subject to the bonus payment limitations, and the compensation structures of all other executive officers and the 100 most highly compensated employees not subject to the bonus payment limitations.

- **Appoints a Special Master**

The IFR establishes an Office of the Special Master for TARP Executive Compensation. In addition to the Special Master's responsibilities with respect to companies receiving exceptional financial assistance, the Special Master has responsibility for: (1) interpreting EESA, the IFR and other applicable guidance; (2) reviewing bonuses, retention awards and other compensation paid before February 17, 2009 to determine if they were inconsistent with the EESA, the TARP or otherwise contrary to public interest, and where appropriate, negotiating with the TARP recipient and the employee for appropriate reimbursements regarding such payments; and (3) providing advisory opinions to TARP recipients and their employees with regards to compensation payments and compensation structures.

- **Requires Additional Certifications**

The principal executive and principal financial officers of TARP recipients are required to provide certain certifications within 90 days of the completion of any fiscal year during which the TARP recipient had outstanding obligations to the government. The required certifications include: (1) detailed statements specifying that the TARP recipient has complied with the specific provisions of the IFR; (2) identification of the CEOs and the 20 next most highly compensated employees, ranked in order of their compensation; and (3) an acknowledgement of penalties for knowing and willful false or fraudulent statements. Public TARP recipients will file these certifications with Treasury and as an exhibit to their annual report filed with the SEC, while non-public TARP recipients will file them with their primary regulatory agency and Treasury.

- **Specifies that contractual provisions not inconsistent with AARA or the IFR continue to apply**

Contractual provisions between the government and TARP recipients that are not inconsistent with the AARA or the IFR will continue to apply in accordance with their terms. This includes, among other things, contractual provisions restricting the deductibility of CEO compensation in excess of \$500,000.

Bass, Berry & Sims PLC's Financial Institutions Subgroup monitors and advises on developments affecting financial institutions and their holding companies. Our attorneys have extensive experience in this area and provide advice to both public and private financial institutions.

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If you have any questions regarding the issues addressed in this Corporate and Securities Law Alert please feel free to contact any of your regular contacts in the Corporate and Securities Group or any of the attorneys in our Financial Institutions Subgroup or Executive Compensation Subgroup listed below.

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