KIRKLAND ALERT
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Interim Final Rules Regarding Executive Compensation Provisions for TARP Recipients

On June 10, 2009, the Department of Treasury released its most recent set of guidance on the standards for compensation and corporate governance that apply to companies participating in the government's Troubled Asset Relief Program ("TARP"). This guidance generally replaces all guidance previously issued on the subject, and became effective on June 15, 2009. While this most recent guidance is currently limited only to those companies that receive TARP funds and other members of their controlled groups, the rules are a reflection of Washington's current attitudes towards executive compensation and may be a sign of broader regulations to come. Notably, the new guidance does not impose strict caps on compensation.

The new guidance also provides for the appointment of a "Special Master for TARP Executive Compensation" (the "Special Master") to oversee the interpretation and implementation of this guidance at the seven companies receiving "exceptional assistance" under TARP, which is a small subset of TARP recipients (collectively, the "Exceptional Assistance Firms"), as well as the general administration of the new guidance. The Exceptional Assistance Firms include American International Group Inc., Citigroup Inc., Bank of America Corp., General Motors Corp., GMAC LLC, Chrysler and Chrysler Financial. Treasury Secretary Timothy F. Geithner appointed Kenneth R. Feinberg, a Washington D.C. litigator, most notable for his work on the September 11th Victim Compensation Fund, as the Special Master.

BACKGROUND

In October 2008, the Department of Treasury established TARP under the Emergency Economic Stabilization Act of 2008 ("EESA"). Section 111 of EESA provided that certain entities that receive financial assistance from Treasury under TARP will be subject to specified executive compensation and corporate governance standards to be established by the Secretary of the Treasury (the "Secretary"). Section 111 was amended and replaced in its entirety in February 2009 by the American Recovery and Reinvestment Act of 2009 ("ARRA"). This most recent guidance entitled "TARP Standards for Compensation and Corporate Governance; Interim Final Rule" (the "Interim Final Rule") implements the changes mandated by ARRA, subject to certain transition rules, consolidates all of the executive-compensation-related provisions that are specifically directed at TARP recipients into a single rule (superseding all prior rules and guidance), and uses the discretion granted to the Secretary under ARRA to adopt additional standards. However, the Interim Final Rule generally does not modify prior contractual agreements entered into with the Secretary related to executive compensation and corporate governance standards.

Generally, the Interim Final Rule applies to all TARP recipients, which is defined as "any entity that has received or will receive financial assistance under the financial assistance provided under the TARP" ("TARP Recipients"). The Interim Final Rule also generally applies to any related entity of which the TARP Recipient owns at least 50%, or which owns at least 50% of the TARP Recipient, determined using certain rules under the Internal Revenue Code of 1986, as amended. The Interim Final Rule applies for the period during which any obligation arising from financial assistance under TARP remains outstanding (the "TARP Period"). Generally, if the federal government only holds warrants to purchase common stock of a company, or a company merely posts collateral to and receives loans from the Federal Reserve Term Asset-Backed Securities Loan Facility ("TALF") the company will not be considered to be a TARP Recipient and will not be subject to the Interim Final Rule.

HIGHLIGHTS OF SUBSTANTIVE REQUIREMENTS

Compensation Committee and Governance Standards

- The Interim Final Rule establishes certain governance standards regarding executive compensation for TARP Recipients. Specifically, the Interim Final Rule requires TARP Recipients to establish a compensation committee composed of independent members of the board of directors if they have not already done so (provided that private companies receiving less than $25,000,000 of assistance may continue to use their full Board) and such committee must generally do, and certify that it has done, the following:

- discuss, evaluate, and review with senior risk officers at least every six months the compensation plans of senior executive officers ("SEOs") and the risks these plans pose to the TARP Recipient. While the term SEO is generally defined consistently with SEC regulations to include the CEO, CFO, and the three other most highly compensated senior executive officers, analogous rules apply to TARP Recipients that do not have securities registered with the SEC (i.e., private companies);

- identify and limit the features in the SEO compensation plans that could lead SEOs to take unnecessary and excessive risks that could threaten the value of the TARP Recipient;

- identify and limit any feature in the employee compensation plans that pose risks to the TARP Recipient to ensure that the TARP Recipient is not unnecessarily exposed to risks, including any feature in those plans that would encourage behavior focused on short-term results rather than long-term value creation;

- discuss, evaluate, and review at least every six months the terms of each employee compensation plan and identify and eliminate the features in each plan that could encourage the manipulation of reported earnings of the TARP Recipient to enhance the compensation of an employee; and

- the board of directors must adopt an excessive or luxury expenditures policy, file such policy with Treasury, and post the text of this policy on such TARP Recipient's website.

Executive Compensation Limits

In addition to requiring the compensation committee activities described above, the Interim Final Rule also clarifies and expands the previous rules and regulations governing TARP Recipients with respect to the limitations on executive compensation. Specifically, the Interim Final Rule:

- requires TARP Recipients to clawback all bonuses paid to its SEOs and the next 20 most highly compensated employees that were based on materially inaccurate performance criteria unless the TARP recipient can demonstrate that it would be unreasonable to do so;

- prohibits TARP Recipients from making golden parachute payments upon a termination of employment or upon a change in control to its SEOs or any of the next five most highly paid executives;

- limits bonus payments to SEOs and other highly compensated employees (with the number of employees to whom this restriction applies contingent on the amount of TARP assistance received), with an exception for certain restricted stock awards that do not exceed one-third of total compensation (e.g., $50,000 restricted stock bonus limitation for an executive with total compensation, including such award, of $150,000); and

- prohibits tax gross-up payments to the SEOs and the 20 next most highly compensated employees.

Shareholder Role and Required Disclosure

The Interim Final Rule refines the role of shareholders and the required disclosure with respect to compensation decisions. Specifically, the Interim Final Rule:

- requires the compensation committee of the TARP Recipient to provide a narrative explanation of its risk analysis regarding how compensation arrangements discourage excessive risk-taking and earnings manipulation, and to include such information in the appropriate public filings, or, if the company is not a reporting company, to its primary regulatory agency and Treasury;

- requires the CEO and the CFO of the TARP Recipient to certify that all of the steps generally described herein have been followed;

- requires TARP Recipients to permit shareholders to have a non-binding vote on executive compensation packages (i.e., say-on-pay);

- requires disclosure of any compensation consultants engaged by the TARP Recipient and a narrative description of the services provided by any such consultant as well as a description of benchmarking procedures used in the consultant's analysis; and

- expands the required disclosure of perquisites to certain employees with a total value exceeding $25,000 in addition to a narrative description of, and justification for, such benefits.

SPECIAL MASTER

Broadly speaking, the Special Master has extensive discretion regarding the compensation practices of Exceptional Assistance Firms as well as serves as a compliance advisor for all other TARP Recipients. While previous guidance regarding executive compensation for Exceptional Assistance Firms capped annual compensation at $500,000, the new rules replace this bright line rule with a mandate that all compensation decisions of such companies must flow through the Special Master. Specifically, with respect to Exceptional Assistance Firms, this mandate grants the Special Master the authority and responsibility to:

- review all compensation for the senior executive officers and the next 20 most highly compensated employees;

- approve the compensation structure for the senior executive officers and the next 100 most highly paid employees; and

- disapprove plans where salary or other compensation is "inappropriate, unsound or excessive."

The Special Master also has certain duties that extend beyond Exceptional Assistance Firms, including the following:

- administer the provision of EESA that requires the Secretary to review compensation made to employees before February 17, 2009 (e.g., bonuses) to determine whether such payments were inconsistent with the purposes of EESA or otherwise contrary to public interest, and to negotiate appropriate reimbursement, if required;

- interpret the application of the restrictions on executive compensation and corporate governance requirements for TARP Recipient employees under EESA or any applicable guidance to specific facts and circumstances;

- provide advisory opinions, as requested or otherwise as appropriate, regarding payment to, or compensation structures for, other employees of TARP Recipients; and

- perform such other duties as the Secretary may delegate from time to time, including the specific application of all terms and conditions in a contract between the Treasury and a TARP Recipient.

Although the Special Master has broad discretion in making such determinations, the Interim Final Rule does provide a safe harbor requiring the Special Master to automatically approve proposed compensation to employees of Exceptional Assistance Firms where (a) the total annual compensation is not more than $500,000, excluding compensation paid in the form of long-term restricted stock, and (b) the other conditions of the Interim Final Rule are satisfied. Additionally, while the Special Master's authority is, for the most part, discretionary, the Interim Final Rule establishes principles that the Special Master is supposed to follow to determine whether compensation is "inconsistent with the purposes of EESA or is otherwise contrary to the public interest." These principles include addressing the appropriate level of risk in compensation plans, appropriately allocating compensation among various elements of pay (e.g., short- and long-term incentive pay), and ensuring consistent payment for similar roles across similar entities. While the Special Master is required to uphold these general principles in carrying out his duties, it is unclear who will scrutinize his decisions and whether such decisions will be subject to an appeals process.

REGULATORY ROAD AHEAD

Although the Interim Final Rule currently only applies to TARP Recipients, the Treasury Department has affirmatively outlined its position that similar restrictions and conditions should apply to other companies as well. Similarly, the Securities and Exchange Commission has articulated its plans to impose certain TARP related obligations on publicly traded companies, and has proposed legislation that would require say-on-pay procedures. Accordingly, as the Treasury Department continues to issue guidance with respect to TARP Recipients, even those companies that did not receive bailout funds must understand these rules as similar executive compensation restrictions may apply to all companies

The Executive Compensation Group counsels clients on a full spectrum of compensation issues, communicating complex and technical legal concepts in a practical, business-oriented fashion. For more information, please feel free to contact any member of the Executive Compensation Group, including:

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