



WASHINGTON REPORT

Premier analysis of federal legislative and regulatory developments for the nation's 2,000 most advanced life insurance planners, focusing on business, estate, qualified and nonqualified retirement planning.

Counsel

<i>Buchanan Ingersoll & Rooney PC</i>	<i>PricewaterhouseCoopers</i>
Gerald H. Sherman	William Archer
Stuart M. Lewis	Donald Carlson
Deborah M. Beers	
Keith A. Mong	<i>Ricchetti, Inc.</i>
	Steve Ricchetti
	Jeff Ricchetti

AALU

David J. Stertz, *Chief Executive Officer*
 Tom Korb, *Vice President of Policy & Public Affairs*
 Marc R. Cadin, *Vice President of Legislative Affairs*
 Sarah Spear, *Director of Policy & Public Affairs*
 Anthony Raglani, *Assist. Dir. of Policy & Public Affairs*

Federal Policy Group
 Ken Kies
 Matthew Dolan

Sutherland Asbill & Brennan LLP
 Stephen E. Roth
 Eric A. Arnold

2901 Telestar Court, Falls Church, Virginia 22042
 Toll Free: 1-888-275-0092 Fax: 703-641-8119
www.aalu.org

AALU Bulletin No: 09-110

October 9, 2009

Subject: **Additional Analysis of the Executive Compensation Restrictions That Apply to TARP Companies**

Major References: [Treasury Interim Final Rules under Section 111 of the Emergency Economic Stabilization Act of 2008, as amended by the American Recovery and Reinvestment Act of 2009.](#)

Prior AALU Washington Reports: 09-79; 09-71; 09-22; 09-20; 09-07; 08-96

MDRT Information Retrieval Index Nos.: 1600.03; 7400.00

SEE THE CIRCULAR 230 DISCLAIMERS APPENDED TO THE CONCLUSION OF THIS WASHINGTON REPORT.

In June 2009, the Treasury released an interim final rule that provides guidance on the executive compensation and corporate governance standards that apply to companies that participate in the Troubled Asset Recovery Program ("TARP") (see Bulletin No. 09-71). Since the release of this guidance, there have been questions about what types of compensation arrangements TARP companies can and cannot provide to their executives. This Bulletin provides a more detailed analysis of the TARP restrictions, with a focus on the specific types of compensation arrangements that can and cannot be provided by TARP companies.

Scope of the TARP Compensation Restrictions

The TARP compensation restrictions generally apply to all entities participating in TARP and to any related entities in which there is at least a 50% ownership interest, determined using certain provisions

of Revenue Code sections 414(b) and (c) (using 50% instead of 80%) (i.e., the controlled group rules for qualified plan purposes).

The restrictions generally apply for the period during which any obligation arising from financial assistance under TARP remains outstanding ("TARP period"), except for any period during which the federal government only holds warrants to purchase common stock of the TARP company.

In addition, the compensation restrictions generally apply to a company's senior executive officers ("SEOs") and, in certain cases, to other highly compensated employees. A company's SEOs generally include the five named executive officers identified in the company's annual compensation disclosures under the federal securities laws (i.e., the principal executive officer ("PEO"), principal financial officer ("PFO") and the three most highly compensated executive officers (other than the PEO and PFO)). For TARP companies that are not subject to the compensation disclosure rules under the federal securities laws, the companies must determine the SEOs in accordance with rules analogous to those under the federal securities laws.

The Key TARP Compensation Restrictions

The key compensation restrictions that apply to TARP companies are discussed separately below:

(1) No Bonuses, Retention Awards and Incentive Compensation Can be Paid or Accrued: The most significant restriction is that a TARP company cannot pay or accrue any bonus, retention award, or incentive compensation to certain employees during the TARP period. Each of these terms are specifically defined for purposes of applying the restrictions:

(a) Bonus: The term "bonus" is defined broadly to include any payment in addition to any amount payable to an employee for services performed at a regular hourly, daily, weekly, monthly, or similar periodic rate (the amount excluded from the definition of a bonus is referred to hereinafter as "base salary").

The Interim Final Rule provides that a bonus *may* include a contribution to, or other increase in benefits under, a nonqualified deferred compensation plan, regardless of when the actual payment will be made under the plan (emphasis added). It is not clear why the rule used the term "may" to describe when nonqualified contributions and accruals are considered bonuses; although the use of the term clearly suggests that not all such contributions and accruals are considered bonuses. One potential reason for using the term may have been to indicate that employee elective deferrals of base salary may not constitute bonuses, but there is no other guidance addressing this issue.

The Interim Final Rule also provides that a bonus *may* include the forgiveness of a loan or other amount that otherwise may be required to be paid by the employee to the employer (emphasis added). Again, the use of the term "may" indicates that not all forgiveness of indebtedness is a bonus, but there is no guidance on how TARP companies should determine whether or not a particular forgiveness arrangement is a bonus (other than a general statement that such determination is based upon all the facts and circumstances).

In addition, the Interim Final Rule provides that the term "bonus" generally does not include payments to or on behalf of an employee as contributions to any qualified retirement plan, benefits under a broad-based benefit plan, bona fide overtime pay, or bona fide and routine expense reimbursements. For this purpose, the term "benefit plan" is defined to include any employee welfare benefit plan as that term is

defined under ERISA, and any other usual and customary plans such as dependent care, tuition reimbursement, group legal services or cafeteria plans. The Interim Final Rule clarifies that the term does not include a deferred compensation plan or any severance pay plan, whether or not nondiscriminatory, or any other arrangement that provides for payment of severance benefits to eligible employees upon voluntary termination for good reason, involuntary termination, or termination under a window program.

The Interim Final Rule indicates further that, provided the rate of commission is pre-established and reasonable, and is applied consistently to the sale of substantially similar goods or services, commission compensation is not treated as a bonus. For this purpose, the interim rule provides a specific definition of the term "commission compensation," which, among other requirements, provides that the commission compensation must be paid pursuant to a program in existence as of February 17, 2009. In the preamble to the Interim Final Rule, the Treasury noted that many TARP companies have broker-dealer, investment advisory, and insurance divisions, where registered representatives, investment advisers, and agents typically receive commissions based on the amount of sales of financial products or the value of assets under management. The Treasury noted that, in this context, the commission payments characteristically are viewed as a component of base salary rather than bonus compensation.

In summary, the term "bonus" is defined broadly under the Interim Final Rule and would include many of the other components of an executive's total compensation package other than qualified retirement benefits and broad-based welfare benefit plans. As such, the term would include the contributions and accruals under most nonqualified deferred compensation plans (other than elective deferrals of base salary) during the TARP period and other arrangements, including many split-dollar and bonus life arrangements. However, as discussed further below, some of these arrangements may be excluded under the exception for certain legally binding bonuses as of February 11, 2009.

(b) Retention Award: The term "retention award" is generally defined as any payment to an employee - other than a payment of commission compensation, a payment made pursuant to a qualified retirement plan, a payment made pursuant to a benefit plan, or a payment of a fringe benefit, overtime pay, or reasonable expense reimbursement - that (i) is not base salary; (ii) is contingent on the completion of a period of future service with the TARP company or the completion of a specific project or other activity of the TARP company; and (iii) is not based on the performance of the employee (other than a requirement that the employee not be separated from employment for cause) or the business activities or value of the TARP company.

The Interim Final Rule provides that, with respect to newly hired employees, a payment that will be made only if the new hire continues providing services for a specified period generally constitutes a retention award (e.g., a signing bonus that must be repaid unless the newly hired employee completes a certain period of service). As an additional example of such an award, the Interim Final Rule references a "make-whole" agreement under which a newly hired employee is provided benefits intended to make up for benefits foregone at his or her former employer and that are subject to a continued service period vesting requirement.

The Interim Final Rule also addresses the extent to which, if any, deferred compensation plans are retention awards. In general, whether a benefit under a deferred compensation plan that is subject to a service vesting period is a retention award depends on all the facts and circumstances. In this regard, the interim rule provides that, to the extent an employee continues to accrue, or becomes eligible to accrue, a benefit under a plan the benefits under which have not been materially enhanced for a significant period of time prior to the employee becoming an SEO or most highly compensated employee (including through expansion of the eligibility for such plan), the benefits accrued generally will not be a retention award.

However, to the extent the plan is amended to materially enhance the benefits provided under the plan or to make such employee eligible to participate in such plan, and such benefits are subject to a requirement of a continued period of service, the interim rule provides that such an amendment generally will be a retention award. Note that it appears that most contributions and accruals under nonqualified deferred compensation plans would constitute bonuses (as discussed above), except for elective deferrals of base salary.

(c) **Incentive Compensation:** The term "incentive compensation" means compensation provided under an incentive plan, which the interim rule defines to include (i) any plan providing compensation intended to serve as an incentive for performance to occur over a specified period, whether such performance is measured by reference to financial performance of the TARP company or an affiliate, the employer's stock price, or any other performance measure; and (ii) any plan providing stock or options or other equity-based compensation such as restricted stock units or stock appreciation rights, except for the payment of base salary or other permissible payments in stock, stock units, or other property.

The number of executives of a TARP company who are subject to the prohibition on bonuses, retention awards and incentive compensation depends on the amount of financial assistance the company receives under TARP:

Total TARP Financial Assistance	Executives Subject to TARP Bonus Restrictions
less than \$25 million	the company's most highly compensated employee (i.e., one employee)
at least \$25 million but less than \$250 million	the five most highly compensated employees
at least \$250 million but less than \$500 million	the CEOs (i.e., 5 officers) and the ten next most highly compensated employees.
\$500 million or more	CEOs and the twenty next most highly compensated employees

The Interim Final Rule also includes special rules for purposes of applying this prohibition. For example, the guidance includes an anti-abuse rule to address circumstances in which a bonus that was not permitted to accrue during the year an employee was covered by the bonus limitation is paid to the employee in a subsequent year when the employee is no longer covered by the bonus limitation, but is designated as some other form of payment such as a salary increase or a stock option grant. In such a case, the payment in the subsequent year may be recharacterized as a payment of the bonus that was not permitted to accrue in the previous year.

The Interim Final Rule also clarifies that a bonus, a retention award, or incentive compensation that an employee accrues while he or she is not subject to the prohibition and is payable at a time when the employee has become subject to the prohibition, may not be paid until the employee is no longer subject to the prohibition.

(2) **Exception for Certain Long-Term Restricted Stock or Restricted Stock Units:** The Interim Final Rule provides an exception from the prohibition on bonuses, retention awards and incentive compensation for certain long-term restricted stock or restricted stock units that meet the following conditions and limitations:

(a) the restricted stock or restricted stock units are issued with respect to the common stock of the TARP company;

(b) the restricted stock or restricted stock unit may not become transferable, or payable in the case of a restricted stock unit, at any time earlier than permitted under the following schedule (except as necessary to reflect a merger or acquisition of the TARP Company):

(i) 25% of the shares or units granted at the time of repayment of 25% of the total financial assistance received under TARP;

(ii) an additional 25% of the shares or units granted (for an aggregate total of 50% of the shares or units granted) at the time of repayment of 50% of the total financial assistance received under TARP;

(iii) an additional 25% of the shares or units granted (for an aggregate total of 75% of the shares or units granted) at the time of repayment of 75% of the total financial assistance received under TARP; and

(iv) the remainder of the shares or units granted at the time of repayment of 100% of the total financial assistance received.

Note that there is a special vesting rule for restricted stock that becomes substantially vested (other than restricted stock for which the employee makes an 83(b) election to be taxed at the time of grant) - a portion of the restricted stock may be made transferable as may reasonably be required to pay the federal, state, local, or foreign taxes that are anticipated to apply to the income recognized due to this vesting, and the amounts made transferable for this purpose do not count toward the percentages in the schedule above;

(c) the employee must be required to forfeit the restricted stock or restricted stock unit if the employee does not continue performing substantial services for the TARP company for at least two years from the date of grant, other than due to the employee's death or disability, or a change in control event (as defined for either 280G or 409A purposes) with respect to the TARP company before the second anniversary of the date of grant; and

(d) the total value of all long-term restricted stock or stock units granted during the TARP company's fiscal year cannot exceed one third of the employee's annual compensation for that fiscal year.

For this purpose, the term "annual compensation" means the dollar value of the total compensation for the applicable fiscal year as determined pursuant to Item 402(a) of Regulation S-K under the federal securities laws (i.e., the compensation disclosure rules for the named executive officers of publicly-traded companies). This definition applies whether or not the TARP company is publicly traded and applies to all of the employees subject to the restrictions (and not just the named executive officers). The Interim Final Rule expressly provides that actuarial increases in pension plans and above market earnings on deferred compensation are not required to be included in annual compensation. In addition, the Interim Final Rule provides that, in determining an employee's annual compensation, all equity-based compensation granted in fiscal years ending after June 17, 2009 will only be included in the calculation in the year in which it is granted at its total fair market value on the grant date, and all equity-based compensation granted in fiscal years ending prior to June 17, 2009 will not be included in the calculation of annual compensation for any subsequent fiscal year.

(3) Exception for Certain Legally Binding Bonuses as of February 11, 2009: The Interim Final Rule provides an exception from the prohibition on bonuses, retention awards and incentive compensation for certain bonus payments required to be paid under a valid employment contract if the employee had a legally binding right under the contract to a bonus payment as of February 11, 2009.

For this purpose, the determination of whether a legally binding right existed as of February 11, 2009 is based on the applicable guidance under Code section 409A, which provides that, in general, an employee has a legally binding right to an amount if the right is enforceable by contract, statute or other law. Such a right may exist even where the amount may be reduced or eliminated by operation of the objective terms of the plan or contract, including a provision that creates a substantial risk of forfeiture (i.e., a vesting requirement). For example, an employee may have a legally binding right to a bonus even though the bonus is only payable if certain objective performance targets are met with respect to a future year.

In contrast, an employee does not have a legally binding right to a bonus to the extent the bonus could be unilaterally reduced or eliminated by the employer or another person after the services creating the right to the bonus have been performed. This negative discretion will be recognized unless it lacks substantive significance, or is available or exercisable only upon a condition.

The Interim Final Rule emphasizes that the exception applies only if the bonus is paid in accordance with the terms of the contract as of February 11, 2009, and any subsequent amendment to the contract to increase the amount payable, accelerate any vesting conditions, or otherwise materially enhance the benefit available to the employee under the contract will cause the bonus payment to fall outside of the exception. However, the Interim Final Rule provides that an amendment to reduce the amount of the bonus payment or to enhance or include service-based or performance-based vesting requirements or holding period requirements will not cause the bonus to fall outside of the exception.

The Interim Final Rule includes a number of specific examples of how this exception for legally binding bonuses as of February 11, 2009 applies. The examples generally address bonuses awarded or granted for service periods beginning before February 11, 2009 (e.g., 2008 calendar year discretionary bonus approved by the compensation committee of the board before February 11, 2009; RSUs subject to a three-year vesting requirement granted prior to February 11, 2009). However, the examples do not address how the exception may apply to certain bonuses for service periods commencing after February 11, 2009.

For example, if an employee has an employment agreement which provides that for each year during the term of the employment contract the employee is entitled to a bonus of a specified dollar amount or percentage of base salary if certain performance conditions to be specified by the compensation committee of the board are satisfied. In addition, as of February 11, 2009, the contract had a term that covered the 2009, 2010 and 2011 calendar years, with a one-year evergreen extension applicable each year thereafter unless one of the parties notifies the other at least 60 days before the end of the current calendar year that the term of the contract will not be extended beyond that year. Under this fact pattern, good arguments can be made that the employee has a legally binding right to the bonus payments as of February 11, 2009 for at least the 2009, 2010 and 2011 calendar years, even though the compensation committee has not designated the specific performance conditions that must be satisfied. It is also not clear whether the exception would apply to any calendar years thereafter during any evergreen extensions of the term. Although the contract essentially can be terminated unilaterally by the employer by providing the required advance notice, it is not clear whether that is negative discretion (i.e., no legally binding right) or is simply a condition requiring continued employment (i.e., a legally binding right).

(4) No Golden Parachute Payments: The Interim Final Rule prohibits a TARP company from making a golden parachute payment to an SEO or the next five most highly compensated employees during the TARP period. For purposes of this prohibition, the term "golden parachute payment" is defined broadly to include any payment for departure from a TARP company for any reason, other than a payment for services performed or benefits accrued, a payment from a qualified retirement plan, a payment due to an employee's death or disability and a severance payment required by state statute or foreign law. The Interim Final Rule also treats as a golden parachute payment any amount due upon a change in control event of the TARP company (as defined for purposes of either Revenue Code section 280G or 409A).

This prohibition applies to the first dollar of any golden parachute payment, which is different from the general golden parachute rules under Revenue Code sections 280G and 4999, which generally apply only if the aggregate golden parachute payments (which are defined differently from the TARP guidance) exceed three-times the employee's base amount, which generally is the average taxable compensation from the employer for the previous five calendar years.

In addition, the Interim Final Rule provides that a golden parachute payment is treated as paid at the time of the employee's departure, regardless of when the amounts are actually paid. Accordingly, TARP companies and employees may not avoid the restriction by deferring payment of any golden parachute payment past the end of the TARP period.

(5) No Tax Gross-Up Payments: The Interim Final Rule prohibits TARP companies from providing tax gross-ups or other reimbursements for the payment of taxes to any of the SEOs and next twenty most highly compensated employees relating to severance payments, perquisites, or any other form of compensation. However, this prohibition does not include certain international tax equalization arrangements intended to compensate an employee for certain different taxes on account of an overseas assignment.

Summary of Additional Executive Compensation and Corporate Governance Standards

The Interim Final Rule sets forth a number of additional executive compensation and corporate governance standards that apply to TARP companies other than those discussed above. Some of the additional standards that should be considered in determining the type of compensation arrangements that can be provided to executives subject to the TARP restrictions are summarized briefly below (and, in some case, are discussed in more detail in *Washington Report No. 09-71*):

(1) Clawback of any Bonus Based on Materially Inaccurate Performance Criteria: TARP companies must ensure that any bonus, retention award, or incentive compensation paid or accrued during the TARP period to an SEO or one of the next twenty most highly compensated employees is subject to a provision for recovery or "clawback" by the TARP company if the payments or accruals were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

(2) \$500,000 Compensation Deduction Limitations for Covered Executives - Revenue Code section 162(m)(5): The preamble to the Interim Final Rule indicates that the Treasury generally requires all TARP companies to agree to limit deductions in accordance with new Revenue Code section 162(m)(5), regardless of whether they are technically subject to the new limitation. This new section provides that certain companies participating in TARP cannot deduct executive compensation in excess of \$500,000 for each of their covered executives (i.e., generally the chief executive officer ("CEO"), the chief financial officer ("CFO"), and the three highest compensated officers other than the CEO or CFO).

(3) Establish a Compensation Committee of Independent Directors: TARP companies must establish a compensation committee composed of independent members of the board of directors to fulfill a number of duties.

(4) Monitor and Limit Incentives for CEOs to Take Unnecessary and Excessive Risks Threatening to the TARP Company's Value: The compensation committee must discuss, evaluate, and review at least every six months with senior risk officers CEO compensation plans and employee compensation plans and the risks these plans pose to the TARP company, and must identify and eliminate the features in the compensation plans that could lead CEOs or other employees to take unnecessary and excessive risks that could threaten the value of the TARP company, including any features that would encourage behavior focused on short-term results rather than long-term value creation.

(5) Prohibit Employee Compensation Plans That Would Encourage Manipulation of Earnings Reported by the TARP Company to Enhance an Employee's Compensation: The compensation committee must discuss, evaluate, and review at least every six months the terms of each employee compensation plan and identify and eliminate the features in the plan that could encourage the manipulation of reported earnings of the TARP company to enhance the compensation of an employee.

(6) Adopt an Excessive or Luxury Expenditure Policy: The board of directors of a TARP company must adopt an excessive or luxury expenditures policy, file this policy with the Treasury, and post the text of this policy on its internet website.

(7) Disclose Certain Perquisites Offered to CEOs and Certain Highly Compensated Employees: A TARP company must disclose to the 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.

(8) Disclose Compensation Consultants: A TARP company must disclose to the Treasury and its primary federal regulator annually whether the TARP company, the board, or the compensation committee has engaged a compensation consultant and all types of services the compensation consultant or any of its affiliates has provided during the past three years.

(9) "Say on Pay" Requirements: A TARP company is required to permit a nonbinding shareholder resolution on CEO compensation.

(10) Special Master for TARP Executive Compensation: The Interim Final Rule establishes the Office of the Special Master for TARP Executive Compensation ("Special Master") to address the application of these rules to TARP companies and their employees.

Cautions About Advising Executives and Companies That May be Subject to the TARP Restrictions

Although this *Washington Report* provides a more detailed analysis of the types of compensation that can be provided to certain executives of TARP companies, there are a number of special rules and exceptions that may apply. For example, for companies receiving exceptional financial assistance under TARP, the Special Master is required to review and approve compensation payments and compensation structures applicable to the CEOs and certain highly compensated employees. In addition, there are detailed effective date rules (see *Washington Report No. 09-71*) and special rules that may apply when a company is no longer subject to the TARP restrictions (which generally occurs when a TARP company repays all of the financial assistance received under TARP).

For these reasons, an individual advising an executive or company that may be subject to the TARP restrictions should not put in place or modify any compensation arrangements unless the individual fully understands the nature of the company's participation in TARP, all of the executive's prior and existing compensation arrangements and the TARP compensation restrictions and corporate governance standards. To obtain this level of understanding, it is likely that a number of individuals would have to be involved in the decision process, including senior legal, financial and executive compensation representatives of both the company and executive.

Any AALU member who wishes to obtain a copy of the Interim Final Rule may do so through the following means: (1) use hyperlink above next to "Major References," (2) log onto the AALU website at www.aalu.org and enter the *Member Portal* and select *Current Washington Report* for linkage to source material or (3) email Anthony Raglani at raglani@aalu.org and include a reference to this *Washington Report*.

In order to comply with requirements imposed by the IRS which may apply to the *Washington Report* as distributed or as re-circulated by our members, please be advised of the following:

THE ABOVE ADVICE WAS NOT INTENDED OR WRITTEN TO BE USED, AND IT CANNOT BE USED, BY YOU FOR THE PURPOSES OF AVOIDING ANY PENALTY THAT MAY BE IMPOSED BY THE INTERNAL REVENUE SERVICE.

In the event that this *Washington Report* is also considered to be a "marketed opinion" within the meaning of the IRS guidance, then, as required by the IRS, please be further advised of the following:

THE ABOVE ADVICE WAS NOT WRITTEN TO SUPPORT THE PROMOTIONS OR MARKETING OF THE TRANSACTIONS OR MATTERS ADDRESSED BY THE WRITTEN ADVICE, AND, BASED ON THE PARTICULAR CIRCUMSTANCES, YOU SHOULD SEEK ADVICE FROM AN INDEPENDENT TAX ADVISOR.



The mission of AALU is to promote, preserve and protect advanced life insurance planning for the benefit of our members, their clients, the industry and the general public.

For more information about how AALU's advocacy efforts help protect your business and the advanced life insurance marketplace, visit our website at www.aalu.org, or call toll free 1-(888)-275-0092.