

## Congress Imposes Retroactive Executive Compensation Limits on TARP Recipients

On February 17, 2009, President Barack Obama signed into law the American Recovery and Reinvestment Act of 2009 (ARRA), the latest economic stimulus bill, which among other issues, places new limitations on compensation for executives and other highly compensated employees at banks receiving federal bailout funds under the Troubled Assets Relief Program (TARP).

The executive compensation limitations as enacted are more strict than those the Obama Administration proposed on February 4, 2009. Under the administration's plan, senior executives at TARP recipients would have been subject to an annual pay cap of \$500,000. Any compensation beyond this amount would have had to have been in restricted stock or other similar long-term incentive arrangements. The senior executive receiving such restricted stock would only have been able to cash in the stock either after the government had been repaid, or after a specified period if certain conditions were met, including, among other factors, the degree to which the TARP recipient had satisfied repayment obligations, protected taxpayer interests or met lending and stability standards. "Treasury Announces New Restrictions on Executive Compensation," (February 4, 2009) *available at* <http://www.treas.gov/press/releases/tg15.htm>. The Senate's original proposed version of the plan would have limited pay to \$400,000 per year with no bonuses for the 25 most highly compensated employees at any institution receiving TARP funds.

The legislation as enacted and signed into law as part of President Obama's 2009 stimulus package is somewhat

different in scope and extent. The executive compensation limits, contained at Title VII of the Act, apply to *any entity* that has any outstanding TARP obligations, even if those obligations were incurred under the Emergency Economic Stabilization Act of 2008, which established the original TARP program. 12 U.S.C. § 5221. The executive compensation restrictions and requirements are as follows:

- **Exclude Incentives for Excessive Risk Taking:** The Treasury Secretary (the Secretary) is required to establish standards for a TARP recipient to limit executive compensation so as to exclude incentives for senior executive officers to take unnecessary and excessive risks that threaten the value of the institution.
- **Recovery for Materially False Statements:** The Secretary is required to provide for the recovery by a TARP recipient of any bonus, retention award, or incentive compensation paid to any of the 25 most highly compensated employees, based on statements of earnings or revenues that are later found to be materially false.
- **Golden Parachutes:** The Secretary is required to provide standards prohibiting golden parachutes from being given to the ten most highly paid employees. For purposes of the Act, a "golden parachute" is defined as "any payment to a senior executive officer for departure from a company for any reason, except for payments for services performed or benefits accrued."
- **Bonus Limitations:** The Secretary is required to provide standards prohibiting the payment or accrual of any bonus, retention award, or incentive compensation to the most highly compensated employees. The number of employees to which the bonus prohibition applies is dependent upon the amount of TARP funds that the recipient has outstanding. For recipients that receive less than \$25 million, the prohibition applies only to the

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most highly compensated employee. For recipients that receive at least \$25 million, but less than \$250 million, the prohibition applies to the five most highly compensated employees. For recipients that receive at least \$250 million, but less than \$500 million, the prohibition applies to the 15 most highly compensated employees. For recipients that receive \$500 million or more, the prohibition applies to the 25 most highly compensated employees. The Secretary has the discretion to increase the number of employees at any given institution to which the prohibition applies. *The prohibition does not apply to valid written employment contracts entered into on or before February 11, 2009.*

- **Long-Term Stock Compensation:** Notwithstanding the prohibition on bonuses, retention awards, or incentive compensation, TARP recipients may compensate otherwise affected employees in the form of long-term restricted stock that: (a) does not fully vest during the period in which there is any outstanding obligation arising from financial assistance provided under the TARP, (b) has a value no greater than one-third of the employee's annual compensation, **and** (c) complies with any other terms and conditions that the Secretary determines.
- **Board Compensation Committee:** Each TARP recipient is required to establish a Board Compensation Committee, composed entirely of independent directors, for the purpose of reviewing employee compensation plans. For non-publicly traded companies that receive less than \$25 million in TARP assistance, the entire board will fulfill this function.
- **Limitation on Luxury Expenditures:** Each institution receiving TARP funds must establish a company-wide policy prohibiting excessive or luxury expenditures. Covered luxuries may include those related to entertainment or events, office and facility renovations, aviation or other transportation services, or other activities or events that are not reasonable expenditures conducted in the normal course of business operations.
- **"Say-on-Pay" - Shareholder Vote on Executive Compensation:** Each TARP recipient is required to conduct a shareholder vote on executive compensation. The vote is not binding on the board of directors.

- **Retroactive Review:** The Secretary is required to review bonuses, retention awards, and other compensation paid to the 25 most highly compensated employees of any company receiving TARP funds before the enactment date of the Act to determine whether any such payments were inconsistent with the purposes of the executive compensation provisions of the Act. If the Secretary determines that any payment was "inconsistent with the purposes" of the Act, or was "otherwise contrary to the public interest," the Secretary is required to seek to negotiate a refund of such payments.
- **Compliance Certification:** The chief executive officer and chief financial officer of each TARP recipient must certify that the institution has complied with all executive compensation restrictions. Public companies must file this certification with the Securities and Exchange Commission, together with its annual filings. Private companies must file this certification with the Secretary.
- **Withdrawal Without Impediment:** The Secretary, in consultation with the appropriate federal banking agency, shall permit a TARP recipient to repay any assistance previously provided under the TARP. The recipient does not need to replace the assistance with Tier 1 capital.

### *Pepper Points*

The Act's executive compensation limits may have a variety of unintended consequences. Notwithstanding public and governmental scrutiny over their compensation practices, banks are likely to increase executives' base salary so as to avoid the need for incentive pay, and increase the amount of long-term stock available for bonuses. Institutions may also face recruitment and retention obstacles not only for managerial employees, but also for traders, analysts, and others who may still be covered by the Act as among the most highly compensated employees in the company. The Act may also cause TARP recipients to repay TARP funds quickly so as to avoid the new restrictions — not necessarily a bad thing from taxpayers' perspective.

In contrast, the new limitations on "luxury expenditures" do not take into account the likely depressing effect such limitations will have on the travel and hospitality industries — similar to the impact on restaurants of the ban on

so-called “three-martini lunches” a generation ago. These industries tend to employ large numbers of low-skilled workers, who are unlikely to find new jobs easily.

The debate over executive compensation limits now turns to the regulatory process, as the Act requires the Treasury Department to initiate several areas of rulemaking. Regulators will have to address several questions left unanswered by the Act. For example, are banks that have taken TARP funding prohibited from paying bonuses for 2008 performance that are now becoming due? Will institutions have to restate their 2008 financial results due to the potential retroactive impact of the Act? How will the Act affect disclosures required in institutions’ 2009 proxy statements? Affected institutions should monitor upcoming rulemaking notices and provide appropriate comment when needed.

While there is little doubt of the authority of Congress to impose limitations and attach strings to its spending power (think the 55-mph speed limit and the setting of the drinking age at 21), the direction to recoup from prior years what had been paid by a company (presumably after receiving approval of the competent authority for the entity), if it appears “excessive,” could lead to significant litigation.

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## New Healthcare Privacy Law Affects Bank’s Products

Medical banking is defined as the integration of banking technology, infrastructure and credit with health care administrative operations. In increasing numbers, banks are providing medical banking services such as health care payment services and health savings accounts. Since the passage of the Health Insurance Portability and Accountability Act (HIPAA) there has been some confusion regarding the status of banks when they receive protected health information (PHI) when providing these services.

HIPAA applies only to “covered entities” that are health care providers, health plans and health care clearinghouses. Some banks qualify as a health care clearinghouse because they translate nonstandard transactions into the HIPAA standards, and vice versa. However, most banks do not provide HIPAA clearinghouse services, but rather operate as business associates because they receive PHI when providing financial services on behalf of a covered entity. To perform as a business associate, the bank and the covered entity enter into a Business Associate Agreement (BAA). The BAA establishes permitted uses and disclosures of the PHI that the bank receives from the covered entity.

The BAA also requires the bank to implement security safeguards and privacy measures to protect the PHI. However, for a number of reasons BAAs contain terms that do not ensure that proper safeguards and privacy protections are actually implemented. The basic business associate terms mandated by the HIPAA rules do not require contract review or renewal and impose no direct obligation on the business associate to comply with HIPAA.

The Health Information Technology for Economic and Clinical Health Act (HITECH Act), passed as part of the American Recovery and Reinvestment Act (ARRA) of 2009, is designed to strengthen business associate privacy and security protections. These new provisions:

- require business associates to implement the same information security safeguards provided in the HIPAA security rule that a covered entity must implement
- obligate the business associate to provide notice to a covered entity if a system containing PHI is breached
- compel the business associate to terminate the agreement if a covered entity materially breaches the

contract or report the breach to the U.S. Department of Health and Human Services if termination is not possible

- impose stronger controls on the sale of PHI
- apply directly the HIPAA criminal and civil penalties to business associates
- enhance civil penalties from a minimum of \$100 for each violation up to an amount not to exceed \$25,000 per year to a maximum of \$50,000 for each violation, not to exceed \$1.5 million per year, and
- provide funds for enforcement and authorize enforcement by state attorneys general.

### *Pepper Points*

The changes to HIPAA brought by the HITECH Act are aimed at enhancing privacy and security and thereby improving the chain of trust in a nationwide health information technology (HIT) infrastructure, including electronic health records and health information exchanges. As trust increases, more covered entities and patients will use HIT, leading to the creation and delivery of new medical banking services. Although most of the privacy and security changes will not be effective until 12 months

after enactment, banks interested in strengthening their medical banking services can begin now by:

- updating their inventory of business associate agreements
- preparing contract language that complies with the new provisions
- implementing an information security program that complies with the HIPAA security rule, including an incident response program that includes notice of breach procedures, and
- obtaining accreditation from the Electronic Health Network Accreditation Commission (EHNAC) or other credible accrediting organization, that requires compliance with the enhanced HIPAA privacy and security provisions.

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