



## Executive Compensation under the Emergency Economic Stabilization Act of 2008

*On October 3, President Bush signed into law a \$700 billion economic rescue package that imposes limits on the compensation for certain executives of financial firms whose troubled assets may be purchased by the government. Although these limits are aimed at companies that are expected to benefit from the bailout, the stage may be set for market forces to demand similar restraints on other companies' executive compensation practices going forward.*

*This For Your Information discusses the rules affecting executive compensation, including guidance released on October 14 and 15.*

### The Troubled Asset Relief Program

In an effort to stabilize financial institutions and ensure liquidity during the current credit crisis, the [Emergency Economic Stabilization Act of 2008](#) (EESA) creates a federal program to purchase "troubled assets" from the financial institutions that hold them. The Troubled Asset Relief Program (TARP) gives the U.S. Treasury authority to purchase residential and commercial mortgages, mortgage-backed securities and other instruments from financial institutions. EESA also permits Treasury to acquire an equity or debt interest in the financial institution.

The financial rescue plan seeks to ensure that senior executives will not be rewarded by Congress' bailout of their companies by imposing limits on executive compensation for financial institutions that participate in TARP. TARP is effective as of October 3, 2008 and is currently scheduled to expire as of December 31, 2009, but may be extended by Treasury until October 3, 2010 (TARP authorities period).

***BUCK COMMENT.*** *It is important to note that financial institutions that sell troubled assets directly to Treasury will be subject to certain executive compensation limitations discussed below as long as Treasury holds an equity or debt position in the institution, regardless of the expiration date of the TARP authorities period.*

The law includes new caps on the tax deductibility of compensation and bonuses for participating companies' top management, prohibits certain golden parachute arrangements, limits or eliminates severance altogether, enhances "clawback" provisions to recoup compensation, and prohibits incentives to take "unnecessary and excessive risks." These limitations apply to financial institutions that sell assets under TARP and to their senior executive officers (SEOs). Generally, an SEO is a "named executive officer" as defined under the SEC's proxy

disclosure rules (PEO, PFO, or one of the three most highly compensated executive officers of the financial institution or its controlled group). Analogous rules apply to financial institutions that do not have securities registered with the SEC.

On October 14, 2008, Treasury announced the development of three programs under TARP, each with a set of executive compensation and corporate governance standards – the Capital Purchase Program (CPP), the Troubled Asset Auction Program (TAAP), and the Programs for Systemically Significant Failing Institutions (PSSFI). On October 15, Treasury and IRS issued additional guidance relating to the executive compensation provisions.

### Capital Purchase Program (CPP)

Financial institutions that sell troubled assets directly to Treasury (i.e., with no bidding process or market price) will be subject to certain executive compensation limitations as long as Treasury holds an equity or debt position in the institution as a result of the sale. Any financial institution participating in CPP will be subject to more stringent executive compensation rules for the period during which Treasury holds equity or debt issued under this program. The financial institution must –

- ensure that incentive compensation for CEOs does not encourage unnecessary and excessive risks that threaten the value of the financial institution
- require clawback of any bonus or incentive compensation paid to an CEO based on statements of earnings, gains, or other criteria that are later proven to be materially inaccurate
- prohibit any golden parachute payment to an CEO
- agree not to deduct for tax purposes executive compensation in excess of \$500,000 for each CEO.

Treasury issued [Interim Final Rules](#) for these executive compensation standards which are effective immediately, but is requesting comments by November 19, 2008.

**Compensation Committee Requirements.** The regulations impose certain requirements on the financial institution's compensation committee –

- The committee must identify the features in the CEO's incentive compensation arrangements that could lead the CEO to take unnecessary and excessive risks (both long-term and short-term) potentially threatening the value of the financial institution. These arrangements must be reviewed with the institution's senior risk officers within 90 days following the purchase under the CPP.
- The committee must meet at least annually with the institution's senior risk officers to discuss and review the relationship between the financial institution's risk management policies and practices and the CEO incentive arrangements.

- The committee must certify that it has completed the required reviews of the SEO incentive compensation arrangements. Financial institutions with securities registered with the SEC should provide these certifications in the Compensation Discussion and Analysis required in the proxy. Institutions not subject to SEC requirements are required to provide the certifications to their primary regulatory agency.

**Clawback Provisions.** The interim regulations compare the CPP forfeiture standard with those of the Sarbanes-Oxley Act (SOX), which requires the forfeiture by a public company's CEO and the CFO of any bonus, incentive-based compensation, or equity-based compensation received and any profits from sales of the company's securities during the twelve-month period following a materially non-compliant financial report. The CPP standards are significantly broader in that they –

- apply to the three most highly compensated executive officers in addition to the CEO and the CFO
- apply to both public and private financial institutions
- are not exclusively triggered by an accounting restatement
- do not limit the recovery period
- cover not only material inaccuracies relating to financial reporting but also material inaccuracies relating to other performance metrics used to award bonuses and incentive compensation.

**Golden Parachutes.** The regulations define a “golden parachute payment” as a payment made to or for the benefit of an SEO on account of an “applicable severance from employment” to the extent the aggregate present value of such payments equals or exceeds an amount equal to three times the SEO's “base amount” (generally as determined by regulations under Section 280G except that references to change in ownership or control are treated as referring to an applicable severance from employment).

**BUCK COMMENT.** *It is important to note that for this purpose, a golden parachute is not tied to a change in ownership or control as is the case for all other parachute payments under Section 280G. Further, since these provisions apply while Treasury holds an equity or debt instrument in the financial institution, it would not be surprising to see executives seeking greater retention-related bonuses payable during or after such period. Alternatively, it may be possible to retain severance provisions but withhold payment of such severance until after Treasury no longer holds an interest. This would need to be carefully crafted in light of deferred compensation rules under Section 409A.*

The regulations define an applicable severance from employment as any SEO's severance from employment with the financial institution by reason of involuntary termination of employment or in connection with any bankruptcy filing, insolvency, or receivership of the financial institution. In either case the employer is determined under controlled group rules (other than “brother-sister” controlled groups).

Under the regulations, an involuntary termination may include the financial institution's failure to renew a contract at the time it expires. In addition, an SEO's voluntary termination from employment may be considered involuntary if it is for "good reason" as defined under the Section 409A regulations.

A payment on account of an applicable severance from employment means a payment that would *not* have been payable if no applicable severance had occurred and any amounts that are accelerated because of the severance.

**BUCK COMMENT.** *The regulations currently do not provide for any special treatment when only a portion of nonvested payments may be accelerated as a parachute payment. Thus, it appears that the full value of any severance payment made that was not yet vested as of the employee's termination date would be treated as a parachute payment.*

Any payment under a tax qualified retirement plan is exempt from parachute treatment.

In the event that a financial institution that sold troubled assets to Treasury through the CPP is acquired by an unrelated entity, the acquiring entity will *not* become subject to the golden parachute rules merely as a result of the acquisition. Any employees of a selling financial institution who were SEOs prior to the acquisition will be subject to the golden parachute rules until the first anniversary following the acquisition.

## Troubled Asset Auction Program (TAAP)

When a financial institution's troubled assets are sold through an auction and Treasury's purchases of the institution's assets exceed \$300 million in the aggregate (including direct purchases), the institution would fall under the Troubled Asset Auction Program (TAAP). If Treasury acquires the assets exclusively in a "direct purchase" transaction, the CPP provisions (as described above) or PSSFI provisions (as described below) would apply.

**No Golden Parachutes under New Contracts.** Under TAAP, a financial institution is prohibited from entering into any new employment contract with an SEO that provides a golden parachute in the event of an applicable severance from employment. Importantly, the prohibition would not extend to payments to senior executives under existing contracts. These provisions apply only to arrangements entered into during the TARP authorities period regardless of whether Treasury ceases to hold an equity or debt position in the financial institution.

**BUCK COMMENT.** *Since this provision only applies to agreements entered into during the TARP authorities period, it would appear to create an incentive for executives to seek golden parachute provisions added to agreements prior to the financial institution selling assets under TAAP. Once the institution is covered under TAAP, it may be difficult to attract new senior executives, promote individuals to senior executive positions, or retain senior executives when their contracts are up for renewal.*

Treasury issued guidance on this restriction in [Notice 2008-TAAP](#) on October 15, 2008. The definitions and determinations of SEO, golden parachute payment, applicable severance from employment, and involuntary termination, essentially mirror the CPP provisions as described above. Thus, applicable severance payments may result from an involuntary termination or in connection with any bankruptcy filing, insolvency, or receivership of the financial institution, but *not* a change in ownership or control.

The notice indicates that a new employment contract includes any material compensatory contract (whether or not written) entered into on or after the date in which the financial institution is first covered under TAAP. For this purpose, a contract that is renewed is treated as entered into on the date of the renewal. Generally, a contract that provides automatic renewal but gives the employer discretion to terminate the contract before renewal will be treated as a new contract as of the renewal date.

In addition, if a contract is materially modified, it is treated as a new contract as of the date of the modification. Generally, a contract is materially modified if it is amended to increase the amount of compensation payable to the employee, to accelerate the date on which vesting occurs, or to accelerate payment.

The guidance contains special rules for acquisitions, mergers, or reorganizations. In the event that a financial institution that sold troubled assets to Treasury under TARP is acquired by an unrelated entity, the troubled assets sold prior to the acquisition are *not* aggregated with any assets sold by the acquiring entity prior to or after the acquisition. However, if troubled assets of the acquired financial institution are sold by the acquiring entity's controlled group (including the financial institution in the case of a stock acquisition), those assets must be aggregated with any assets sold by the acquiring entity (before or after the acquisition) for purposes of determining whether the acquiring entity is subject to these provisions.

**Tax Provisions.** With respect to applicable taxable years during the TARP authorities period, new Internal Revenue Code Sections 162(m)(5) and 280G(e) apply to financial institutions that sell assets under TAAP (applicable employer).

#### *New Section 162(m)(5)*

The amount of compensation paid to a covered executive of an applicable employer (whether in the form of a corporation, partnership, grantor trust, or similar entity) that may be deducted is capped at \$500,000. There is no exception for commission-based or performance-based compensation (including stock options). For purposes of the deductibility limit, a covered executive is anyone serving as a CEO or CFO, or who is one of the three highest compensated officers (other than the CEO and CFO), during the portion of any taxable year the TARP authorities period is in effect. The three highest compensated officers (other than the CEO and CFO) are generally determined in the same manner as in the proxy disclosure rules for SEC registrants. For institutions that are not SEC registrants, analogous rules will apply.

In addition, the law limits the deduction for deferred compensation. The deferred deduction is limited for a taxable year to \$500,000, reduced (but not below zero) by the sum of (a) the executive remuneration for that year, plus (b) the portion of the deferred executive remuneration deduction that was taken into account in a preceding taxable year.

For example, a covered executive is paid \$400,000 in salary by an applicable employer in 2009 (an applicable taxable year) and obtains a legally binding right attributable to services performed in 2009 to receive a payment of \$250,000 in 2015. The full \$400,000 in cash salary is deductible under the \$500,000 limit in 2009. In 2015, the employer's deduction with respect to the \$250,000 is limited to \$100,000, which represents the unused portion of the \$500,000 limit from 2009 (and no deduction will be allowed for the remaining \$150,000).

Treasury has released [Notice 2008-94](#) providing guidance on new Section 162(m)(5), including controlled group rules used in determining applicable employer, special rules associated with acquisitions, mergers, or reorganizations following a financial institution's sale of assets under TARP, and general definitions.

A large portion of the guidance focuses on the determination of deferred deduction amounts and how to allocate these amounts to the employee's services rendered during applicable taxable years for purposes of determining unused deferred deduction limits. Generally, deferred amounts (which would include the spread value of stock options upon exercise) are allocable to specific applicable tax years based on the service period, up until the time the rights to such amounts require no additional future services.

#### *New Section 280G(e) Golden Parachute Payment Limit*

Under Section 280G(e), deductions by applicable employers will be disallowed for excess parachute payments related to the applicable severance from employment of a covered executive (as defined in new Section 162(m)(5) above). Further, the covered executives will be subject to a 20% excise tax on such excess parachute payments. This is an addition to the existing parachute provisions under Section 280G providing similar consequences for excess parachute payments made in connection with a change in ownership or control.

Notice 2008-94 provides guidance on new Section 280G(e), which is similar to the guidance on the CPP's golden parachute provisions described above.

### **Programs for Systemically Significant Failing Institutions (PSSFI)**

Treasury is currently developing a third program to potentially provide direct assistance to certain institutions that are determined, on a case-by-case basis, to be "systematically significant failing institutions." In [Notice 2008-PSSFI](#), Treasury issued limited guidance on the executive compensation standards that will apply to the firms participating in such programs. These standards are similar in all respects to the CPP's executive compensation standards described above, with one significant difference – the full amount of applicable severance payments to CEOs will be treated as golden parachutes without reference to the three times base amount threshold.

## Conclusion

Although the rules outlined above are currently limited to financial institutions that sell assets to Treasury, the impact on executive compensation in general could be far more sweeping. How these rules will affect the behavior of executives, shareholders, compensation committees, lenders, other stakeholders, employment agreements, incentive plan design, proxy disclosures, etc., will be seen over time. In any event, it would seem apparent that corporate governance issues will be at the forefront of any discussions involving executive pay.

Buck's compensation consultants would be pleased to discuss the new financial bailout law and its implications with you.

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*This FYI is intended to provide general information. It does not offer legal advice or purport to treat all the issues surrounding any one topic.*