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Financial Institutions

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# Executive Compensation Provisions of Emergency Economic Stabilization Act of 2008

Under the Emergency Economic Stabilization Act of 2008 (the "Act") enacted today, "financial institutions" that sell troubled assets to the Secretary of the Treasury under the Troubled Assets Relief Program ("TARP") will be required to comply with certain executive compensation requirements and corporate governance standards as well as special rules for the tax treatment of certain compensation paid to their senior executives. The requirements and standards that apply to participating financial institutions differ depending on whether the Secretary (i) purchases the assets directly from the institution or (ii) purchases the assets through an auction process. In the case of direct purchases, there is no minimum amount of participation necessary to subject the institution to the Act's requirements; however in the case of auction purchases an institution only becomes subject to the Act once the purchases exceed $300 million. The special tax provisions of the Act apply only to employers that have sold aggregate assets under TARP that exceed $300 million.

A "financial institution" is broadly defined as any institution, including without limitation, a bank, savings association, credit union, broker-dealer or insurance company, established and regulated under the state or federal laws of the U.S. or its territories or possessions, and having significant operations in the U.S., but expressly excludes any central bank of, or institution owned by, a foreign government.

## 1. New Standards for Executive Compensation and Corporate Governance

Under Section 111(b) of the Act, institutions that sell assets directly to the Secretary without a bidding process or market prices and in which the Secretary receives a meaningful equity or debt position, are required to meet appropriate standards for executive compensation and corporate governance during the period of the Secretary's equity or debt investment, including the following:

- "limits" on compensation that exclude incentives for the "senior executive officers" to take "unnecessary and excessive risks" that threaten the value of the institution;
- provisions for the recovery by the institution of any bonus or incentive compensation paid to a "senior executive officer" based on statements of earnings, gains, or other criteria later proven to be materially inaccurate; and
- a prohibition on the institution's making any "golden parachute payment" to its "senior executive officer."

Other than the term "senior executive officer," which is defined to mean (i) the named executive officer group in the case of public reporting companies and (ii) their counterparts in the case of private companies, these provisions are quite vague. Consequently, it is difficult to predict how restrictive these provisions will be in practice. For example, there is no indication in the statute as to the limits that will be applied to senior executive compensation or the types of incentives that would be considered to encourage senior executives to take unnecessary and excessive risks. Similarly, there is no definition of "golden parachute payment," although later sections of the bill suggest that this provision will place a cap on severance benefits that can be paid to senior executives of approximately three times their annual pay.

Under Section 111(c) of the Act, institutions that sell assets to the Secretary through an auction process, beginning on and after the date that aggregate sales under TARP exceed $300 million (including direct purchases), are prohibited from entering into any new employment agreement with a senior executive officer that provides for a golden parachute payment upon involuntary termination, bankruptcy filing, insolvency or receivership. The new rules do not apply to existing agreements entered into before the date that the threshold is exceeded other than in respect of the tax treatment of golden parachute payments discussed below. It is not clear what will constitute a "golden parachute payment" for this purpose, and the Secretary has two months from adoption of the Act to issue guidance implementing this provision. The provisions in Section 111(c) remain in effect through December 31, 2009 and may be extended by the Secretary to expire no later than two years after the enactment of the Act.

**Executive Compensation Limitations**

- For institutions that sell assets directly to the Secretary without a bidding process or market prices, and in which the Secretary obtains an equity or debt position, there will be limitations on the amounts and types of compensation for senior executive officers as well as clawback provisions.

- For institutions that sell more than $300 million in assets to the Secretary through an auction process, there is a prohibition on any new agreements with senior executive officers providing for a golden parachute payment upon involuntary termination, bankruptcy filing, insolvency or receivership.

- For institutions that sell more than $300 million in assets to the Secretary (other than solely through direct sales without bidding or market prices),

    - the maximum compensation deduction for covered executives is reduced from $1 million to $500,000 and certain amounts (including stock options) that could have been excluded from the $1 million amount will no longer be excludable, and

    - the golden parachute payment excise tax and deduction rules are expanded to cover parachute payments made upon involuntary termination, bankruptcy, liquidation or receivership.

## 2. Tax Treatment of Certain Payments to Covered Executives of TARP Employers

Section 302 of the Act amends the tax treatment of certain payments made to "covered executives" by employers that have sold aggregate assets under TARP exceeding $300 million (a "TARP Employer"). In calculating the aggregate assets sold under TARP, if an employer's only sales of assets are through one or more direct purchases, such sales are excluded from the calculation, while assets acquired from two or more persons that are treated as a single employer under the tax rules applicable to members of a "controlled group of corporations" are aggregated. In general, a "controlled group of corporations" is one or more chains of companies owned by a common parent company and in which each entity in the chain as well as the parent owns at least 80% of the combined voting power or total value of all shares of the subsidiary companies.

The group of "covered executives" to which the Act's special tax rules apply includes the chief executive officer and chief financial officer of the TARP Employer, and the top three highest compensated officers of the TARP Employer (excluding the CEO and CFO), as determined on the basis of the SEC disclosure rules for public reporting companies, that were employed during the portion of any taxable year in which the TARP is in effect. If an employee is a "covered executive" for any year that the Act is in effect, he or she will remain a "covered executive" for all subsequent years that the Act is in effect.

An employer is subject to the special tax rules of the Act for the first taxable year in which it becomes a TARP Employer and for each subsequent year in which the TARP is in effect.

(a) Limitations on Deduction of Executive Compensation by TARP Employers

Section 162(m) of the Internal Revenue Code generally prohibits public companies from deducting compensation in excess of $1 million paid to a "covered employee" in any year. A company's "covered employees" are its CEO and the three highest paid other officers, excluding the CFO, which is different than the group of "covered executives" under TARP as described above. Payments that qualify as performance based compensation and payments that are deferred until after the executive is no longer a covered executive do not count toward this $1 million limit.

For remuneration paid to "covered executives" of TARP Employers, the Act reduces the limitation on deductible compensation from $1 million to $500,000 and includes in the calculation of this lower threshold both (i) all amounts that were earned by the employee in the applicable tax year even if such amounts were deferred to another year and (ii) all performance based compensation, including without limitation stock option gains, received by the covered executive.

(b) Amendment of Parachute Payment Tax Rules for TARP Employers

Sections 280G and 4999 of the Internal Revenue Code impose limitations on compensation deductions on employers and additional excise taxes on employees, in the event certain payments are made in connection with a change in control that exceed three times the employee's "base amount" (the "280G Threshold Amount"). The "base amount" is the average of the employee's last five years' (or such shorter period as the employee has been employed by the applicable employer) taxable income, which ordinarily means base salary and bonus, but will also include, among other things, income from option gains or other equity compensation, which may significantly increase the base amount. If the 280G Threshold Amount is met, the deduction limitation and the additional excise tax are applied not just to the amounts in excess of the 280G Threshold Amount but to the amounts of the parachute payment that exceed one times the base amount.

The Act applies the golden parachute excise tax and deduction rules to payments made to "covered executives" upon a severance from employment with a TARP Employer without regard to whether a change in control has occurred. The Act expands the circumstances under which the golden parachute tax rules apply to include severance amounts paid upon an involuntary termination by the employer and in connection with any bankruptcy, liquidation or receivership of the employer. TARP Employers are expressly prohibited from availing themselves of the provisions under Section 280G that allow exclusion of amounts determined to be "reasonable compensation". The Act expands the forms of entities to which the parachute payment provisions apply beyond corporations to cover any TARP Employer irrespective of the form of entity and regardless of whether the entity's shareholders approve the payment.

The Act's modifications to the golden parachute rules apply to payments made by TARP Employers with respect to severances from employment that occur during the period that TARP is in effect.

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If you have any questions concerning the material discussed in this client alert, please contact the following members of our employee benefits practice group:

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