

Client Alert

October 8, 2008

The Emergency Economic Stabilization Act of 2008: Impact on Executive Compensation

Congress passed the Emergency Economic Stabilization Act of 2008, H.R. 1424 (the "Act") in response to the current financial crisis on October 3, 2008. The Act, which primarily authorizes a \$700 billion economic rescue plan, also imposes significant executive compensation limitations on executives of institutions that participate in the Troubled Asset Relief Program ("TARP") portion of the Act, and amends the golden parachute rules and deductibility limits of the Internal Revenue Code (the "Code") for those same institutions. Specifics of the impact of the Act on executive compensation are described below in Q&A format.

What institutions are subject to the Act's executive compensation limitations?

The executive compensation provisions only apply to financial institutions (generally including U.S. banks, broker-dealers and insurance companies) that participate in the TARP. These are institutions from which the U.S. Treasury will purchase "troubled assets," which are generally defined as residential or commercial mortgages and any securities, obligations or other instruments that are based on or related to such mortgages. The institutions participating in the TARP may be either public or private.

PM&P Observation: While the executive compensation and corporate governance limitations in the TARP are important, they only apply to companies seeking relief, and not to all corporations.

Which executives are subject to the executive compensation limitations?

The limitations under the Act apply only to "senior executive officers" of the financial institutions that participate in the TARP. Senior executive officers are defined as any of the top five executives of a company (i.e., proxy named officers), or their relevant counterparts at private companies.

Are all of the executive compensation provisions under the Act applicable to all senior executive officers of financial institutions participating in the TARP?

No. The Act establishes two separate sets of executive compensation standards depending on how assets were acquired by the Treasury, and the Treasury's ongoing interest in the financial institution:

- A **“Direct Purchase”** occurs when the Treasury:
 - (i) Purchases troubled assets from an individual financial institution where no bidding process or market prices are available, and
 - (ii) Acquires a meaningful equity or debt position in the financial institution as a result of the transaction. The Act does not define a meaningful equity or debt position for these purposes.
- An **“Auction Purchase”** occurs when the Treasury purchases troubled assets of a financial institution that in the aggregate exceed \$300 million (including Direct Purchases).

The nature and the scope of the executive compensation provisions that will apply to a financial institution participating in the TARP will depend on whether it is engaging in a Direct Purchase or Auction Purchase.

What are the executive compensation implications for senior executive officers involved in a Direct Purchase?

Three limitations apply as long as the Treasury remains a debt or equity holder through a Direct Purchase:

- **Limitations on Risky Incentives:** There must be limits on incentive compensation that reward executives for taking unnecessary and excessive risk that threatens the value of the financial institution. The Act does not describe what is meant by “unnecessary and excessive risk;” Treasury will presumably provide detail in future guidance.
- **Clawbacks:** There must be a provision for the recovery by the financial institution of any bonus or incentive compensation paid to a senior executive officer based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate.

PM&P Observation: This provision is similar to Section 304 of Sarbanes-Oxley, but is more expansive in that: (i) it applies to additional executives beyond the CEO and CFO; (ii) it may be triggered even if the institution is not required to restate its financials; and (iii) it is not limited to incentives paid within the previous 12 months.

- **No Golden Parachute Payments:** The financial institution may not make any golden parachute payments to senior executive officers during the time the Treasury holds an equity or debt position. Again, the Act does not define “golden parachute payment” but presumably it refers to the non-deductible compensation paid by corporations pursuant to Sections 280G and 4999 of the Code.

PM&P Observation: This standard appears to limit not only golden parachute benefits from new agreements, *but also golden parachute benefits under existing agreements*. Thus, if institutions want to participate in the Direct Purchase TARP program, they may be forced to amend or obtain waivers of such provisions of employment agreements with senior executive officers before entering into the program.

PM&P Observation: These limitations all appear oriented toward protecting Treasury's investment in the financial institution by limiting risk taking and precluding the use of assets for what are deemed to be inappropriate uses, specifically the payment of incentives in the event of misstated financial statements and the payment of golden parachutes. However, we believe the definition of "risk" will likely be difficult and subjective and largely determined by the individual facts and circumstances of each financial institution. How such situations will be codified by Treasury is unknown at this point.

What are the executive compensation implications for senior executive officers involved in an Auction Purchase?

If the Treasury purchases troubled assets from a financial institution through an auction process and acquires more than \$300 million in troubled assets from the institution (through either Direct Purchases or Auction Purchases), three different compensation restrictions apply to the senior executive officers during the period the TARP is in effect:

- **Prohibition on New Golden Parachutes Arrangements:** Financial institutions may not enter into new employment arrangements with senior executive officers that provide golden parachute payments in the event of an involuntary termination, bankruptcy filing, insolvency or receivership. The ban starts as of the date the aggregate amount of troubled assets sold by the institution exceeds \$300 million and continues for the duration of the TARP, even if the financial institution reduces its participation below \$300 million. Again, the Act does not define "involuntary termination" or "golden parachute" in this specific section, but it does state the Treasury must issue more guidance on this particular topic within two months of the enactment of the Act.
- **New Code Section 162(m)(5) on Deduction Limitations:** The Act amends the current Code Section 162(m) provision that limits the deductibility of compensation exceeding \$1 million to certain covered employees of public companies. Under existing law, a "covered employee" is defined as a public company's CEO and the three most highly compensated officers for the tax year other than the CEO (and excluding the CFO). The existing law also provides important carve-outs for commissions, performance-based compensation (including stock options), and pre-162(m) grandfathered contracts.

The new subsection (5) of Section 162(m) provides special guidance regarding deductibility rules for companies involved in an Auction Purchase, as follows:

- (i) Deductible compensation is capped at \$500,000 annually, rather than \$1,000,000;
- (ii) There are no exceptions for commissions, performance-based compensation, or pre-162(m) grandfathered contracts;
- (iii) The term “covered employee” is expanded to include the CFO during the portion of the taxable year the TARP is in effect;
- (iv) A covered employee in any applicable year will continue to be treated as a covered employee in any year the TARP is still in effect, even if no longer employed;
- (v) The limit applies to public *and private* companies participating in the TARP; and
- (vi) Any deferred compensation that is remuneration for services performed during an applicable tax year during the TARP effective date is generally also subject to such deduction limits.

PM&P Observation: The limit on deductibility will probably have minimal impact on actual compensation levels. While it theoretically increases the cost of executive compensation, most of the companies seeking assistance under the TARP are probably not current taxpayers due to significant losses incurred on the very instruments they are selling to the Treasury.

- **New Section 280G(e) on Golden Parachutes:** The Act adds a new section to the golden parachute rules. Under existing law, golden parachute payments generally consist of amounts and benefits payable to executives of public companies that equal or exceed three times the executive’s “base amount” (generally five years’ annualized W-2 income) and that are triggered by reason of a change in control or ownership of a company. The golden parachute rules render portions of such payments non-deductible to the company and subjects the executive to a 20% excise tax on such amounts. The existing rules apply to “disqualified individuals” (generally officers, 1% shareholders or the highest compensated one percent of the employees of a corporation) and also provide for certain relief for small business corporations and for reasonable compensation for services rendered after the change in control.

The new subsection (e) of Section 280G provides special guidance regarding application of the golden parachute rules for companies involved in an Auction Purchase. Specifically, the golden parachute rules under this section:

- (i) Apply to severance payments made in connection with any bankruptcy, liquidation or receivership (whether or not they are made in connection with a change in control);

- (ii) Do not contain exemptions for reasonable post-deal compensation or small business corporations;
- (iii) Apply only to the CEO, CFO and other top three officers of public companies; and
- (iv) Apply to comparable senior executives at private companies and partnerships.

PM&P Observation: Financial institutions with existing arrangements providing excise tax gross-ups to executives under the existing golden parachute rules should review those arrangements to determine whether the gross-up will apply to excise taxes imposed under this new rule. Unlike the limit on deductibility, this section may result in increased cash cost as the employer funds the excise tax liability (assuming a gross-up is provided). However, we suspect companies may find the increased cost is immaterial as compared to the benefit of offloading troubled assets to the Treasury.

What is the timing of the executive compensation limitations described above?

The executive compensation limitations imposed on Auction Purchases generally apply while the TARP is in effect, which is scheduled to end on December 31, 2009, subject to possible extension until October 3, 2010 at the latest. The limitations pertaining to Direct Purchases apply as long as the Treasury holds debt or equity of the financial institution.

Conclusions

The executive compensation limits of the Act may increase a company's compensation cost. However, the increased cost may pale in comparison to the benefit of a sale of troubled assets to the Treasury. Whether or not the Act's executive compensation reform measures have any teeth or were simply part of the negotiations to get the bill through Congress remains to be seen and will be a function of how they are implemented through the issuance of additional guidance by Treasury.

While companies that do not seek relief under the Act are not directly affected by the provisions, the Act may be a harbinger of future executive compensation and corporate governance reform. For example, "say on pay" legislation was introduced into earlier versions of the Act but dropped before Congressional approval. We anticipate say on pay, along with more generally applicable compensation reform measures, to surface after the Presidential election, particularly given that both major party Presidential candidates support say on pay. In addition, Congress may find it relatively easy to build on the Act's executive compensation provisions in any future executive compensation related legislation that may be applicable to all firms, not just those caught up in the current financial crisis.

Important Notice: Pearl Meyer & Partners has provided this analysis based solely on its knowledge and experience as compensation consultants. In providing this advice, Pearl Meyer & Partners is not acting as your lawyer and makes no representations or warranties respecting the legal, tax or accounting implications or effectiveness of this advice. You should consult with your legal counsel and tax advisor to determine the effectiveness and/or potential legal impact of this advice. In addition, this Client Alert is not intended or written to be used, and cannot be used by you or any other person, for the purpose of (1) avoiding any penalties that may be imposed by the Internal Revenue Code, or (2) promoting, marketing or recommending to another party any transaction or other matter addressed herein, and the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.



**PM
&P** | Pearl Meyer & Partners
Comprehensive Compensation®

www.pearlmeyer.com

NEW YORK

445 Park Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA

One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON

132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE

3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO

123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON

Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES

550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

