

Client Alert

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The Emergency Economic Stabilization Act of 2008, Part II: The Evolving Rules on Executive Compensation

The Emergency Economic Stabilization Act of 2008 (EESA) was signed into law October 3, 2008. The EESA was designed to assist banks and other financial institutions in a time of significant crisis in the domestic and worldwide financial and credit markets. Since that date, the U.S. Treasury Department has made significant progress on the form and function of the specific financial programs to be used to address the current set of issues facing the financial and credit markets.

Associated with each of the financial programs are proposed restrictions on executive compensation, which were deemed appropriate by Congress due to the perception that executive pay was viewed as a contributing factor to the recent financial/credit market meltdown and that executives should not benefit from taxpayer funding. The specific mechanics of the executive compensation restrictions were somewhat unclear on most material points, as discussed in a previous Pearl Meyer & Partners' (PM&P) Client Alert¹. The Treasury has now issued clarifying guidance on executive compensation restrictions for organizations participating in the EESA's financial rescue programs. The Q&A below provides specifics on the three new rescue programs established by the Treasury, each of which has a slightly different set of executive compensation restrictions for participating organizations.

What are the three new programs and which companies are affected?

The Capital Purchase Program (CPP): The CPP, the only one of the three new programs currently active, is intended to encourage financial institutions to build capital, increase the flow of financing to businesses and consumers, and support the economy. Introduced to great fanfare (particularly as the nine largest U.S. banks "voluntarily" joined the program), the CPP calls for the Treasury to purchase up to \$250 billion of senior preferred shares of financial institutions. The CPP covers situations in which "healthy" companies sell preferred shares to the Treasury or the Treasury makes a "direct purchase" of "troubled assets" from companies in financial distress (previously referred to as the "Direct Purchase" program).

¹ See <http://www.pearlmeier.com/knowledgecenter/alerts/ClientAlert-10-08-08.pdf>

PM&P Observation: While the EESA may not have been intended to impose executive compensation restrictions in the context of the purchase of preferred shares from healthy institutions, the Treasury deemed it within its discretion to apply such restrictions. Such a broad interpretation could be a harbinger of future administrative activism on the part of the Treasury.

The Troubled Asset Auction Program (TAAP): Also referred to as the “Auction Purchase” program, the TAAP will cover situations where the Treasury acquires troubled assets from an institution in excess of \$300 million at least partially through auction purchases, rather than through direct purchases.

The Systemically Significant Failing Institutions Program (SSFI): This program will provide for negotiations on a case-by-case basis for direct assistance to certain failing institutions.

Which executive will be affected by the three programs?

The EESA compensation limits apply only to Senior Executive Officers (SEOs) of public or private institutions that participate in any of the three programs. SEOs include the chief executive officer, chief financial officer and the three most highly-compensated executive officers other than the CEO or CFO, as determined *at the time the company enters into the program*. The definition differs from that used for Named Executive Officers under proxy disclosure rules. It exempts certain former officers, but includes executives whose compensation for the current fiscal year (as opposed to the previous fiscal year-end) places them in the top three. Private companies must make an analogy to the public company rules in determining which executives are affected.

PM&P Observation: While companies are advised to use their “best efforts” in determining the SEOs, it may not be easy for some institutions. Among other issues, it will require making a myriad of assumptions with regard to potential incentives and their accounting values. Practically speaking, companies probably will need to identify and track potentially affected executives, and make a final determination of who is covered at year-end. This process is similar to that used for determining Named Executive Officers for the proxy statement, but could potentially yield a somewhat different outcome. However, we expect that Named Executive Officers and the SEOs will be similar, if not identical, for many institutions.

What are the specific compensation limitations on CEOs under the CPP?

Companies – both *public and private* – that participate in the CPP are subject to the following:

1) Limits on Incentives Tied to Unnecessary and Excessive Risk: Incentive compensation programs must be structured to prevent CEOs from taking inappropriate risks during the time that the Treasury holds a stake in those companies. The guidance contains specific steps for Compensation Committees to ensure compliance:

- a) *Senior Risk Officer (SRO) Meeting*: The Compensation Committee must meet with the financial institution's senior risk officers to discuss any incentive or bonus compensation arrangements that might promote unnecessary and excessive risk-taking and jeopardize the institution's value. This meeting must take place within 90 days after a purchase under the CPP. The guidance does not name specific performance measures, as each financial institution faces different material risks based on the unique nature of its business and the markets in which it operates. Instead, the guidance requires the Compensation Committee and the SRO to discuss the company's specific long-term and short-term risks and remove or limit the impact of any arrangements deemed problematic.

PM&P Observation: This provision is likely to present the greatest challenge to affected companies, as virtually any financial metric (such as an earnings measure) could be considered to promote unnecessary and excessive risk-taking by an executive. Moreover, many initially reasonable risks may look unnecessary and excessive in hindsight. For example, an earnings metric that is reasonable at the time it is set may end up incentivizing executives to take unnecessary and excessive risks if it eventually seems unachievable.

PM&P Observation: Variability in performance-based compensation is traditionally directly related to risk (i.e., risk and return are directly related). If plans are changed to reduce the potential for risk, it can impair the pay-for-performance relationship.

- b) *Annual Meeting with SRO*: After their initial meeting, the Compensation Committee must meet with the SRO on an annual basis to discuss and review the relationship between the company's risk management policies/practices and the CEO compensation arrangements.
- c) *Verification of Process in Compensation Discussion and Analysis*: The Compensation Committee must certify annually in the CD&A (or, in the case of private companies, with their primary regulator) that it complied with the above steps. The Treasury provided the following sample language: *"The compensation committee certifies that it has reviewed with senior risk officers the CEO incentive compensation arrangements and has made reasonable efforts to ensure that such arrangements do not encourage CEOs to take unnecessary and excessive risks that threaten the value of the financial institution."*

PM&P Observation: Unlike the Compensation Committee Report (which certifies that members generally reviewed the proxy with management), the

CPP verification is required to be part of the CD&A and is signed by the CEO and CFO, rendering it a “filed” document subject to Exchange Act liabilities. Since the SEC in its expanded disclosure rules specifically removed the Committee Report from the CD&A to avoid this issue, arguably the risk certification also should have been made part of the Report rather than the CD&A.

- 2) **“Clawback” Programs:** There must be a provision in place to recover any bonus or incentive compensation paid to a CEO that was based on financial statements or other performance metric criteria deemed materially inaccurate. The guidance notes that this provision differs from Section 304 of Sarbanes-Oxley in the following respects:
- a) It applies to all CEOs, not just the company’s CEO or CFO;
 - b) It applies to both public and private institutions participating in the program;
 - c) It is not exclusively triggered by a financial restatement;
 - d) It does not limit the recovery period to the previous 12 months; and
 - e) It covers not only material inaccuracies relating to financial reporting, but also inaccuracies related to other performance metrics for awarding bonuses and incentive compensation.

PM&P Observation: In recent years, clawback provisions have become a best practice for all senior executives.

- 3) **Prohibition on “Golden Parachute” Payouts Under Section 280G:** Institutions participating in the CPP program are prohibited from making any golden parachute payments to its CEOs. Unlike the cap on golden parachute payments made outside the CPP context, the CPP golden parachute limits are based on termination events that are not associated with a change-in-control. The EESA amends Section 280G of the Internal Revenue Code to add a provision that specifically addresses “golden parachute payments” for CEOs. For those institutions participating in the CPP, the term “golden parachute payment” refers to any payment in the nature of compensation made to a CEO due to *“applicable severance from employment”* or in connection with bankruptcy, *to the extent that the aggregate present value of such payments equals or exceeds an amount equal to three times the executive’s base amount (i.e., the five-year average of an executive’s compensation)*. For this purpose, an involuntary separation from employment includes payments triggered by:
- a) The company’s unilateral decision to terminate the CEO;
 - b) Employment contract non-renewals; and
 - c) Voluntary terminations by the CEO either for “good reason” (due to a material negative change in the CEO’s employment relationship) or where the CEO had knowledge that absent such resignation, the company would have terminated the CEO had he or she not quit.

Qualified retirement payments are explicitly excluded from the prohibition.

- 4) Deductibility Under Section 162(m): The CPP imposes more strict rules on the deductibility of compensation, under new Code Section 162(m)(5). The deductibility limit is cut to \$500,000 (instead of \$1 million) and exceptions are eliminated for “performance-based compensation,” commissions, and pre-Section 162(m) grandfathered contracts.

PM&P Observation: We expect most companies will treat the nondeductibility of SEO compensation in excess of \$500,000 as an additional cost of doing business. The lack of deductibility for performance-based compensation, coupled with the prohibition on incentives for unnecessary and excessive risk, is likely to result in compensation for SEOs becoming less variable based on performance, potentially resulting in a diminished pay-for-performance relationship and a heavier emphasis on fixed compensation (i.e., salary) combined with a lesser emphasis on incentives.

- 5) Compliance: Before institutions receive any assistance under the CPP, they must first modify and terminate all benefit plans, arrangements and agreements as needed to comply with the CPP restrictions. They also must promise to comply with those limits while they are receiving assistance. In addition, both the institution and the SEO must sign a waiver to the Treasury, releasing them from any executive compensation-related claims resulting from such modifications.

What are the executive compensation limitations under the TAAP?

While this program is still in development, the Treasury has issued guidance regarding compensation for SEOs at institutions participating in the TAAP, including:

- 1) Modification of “Golden Parachute” Payouts Under Section 280G: The definition of “golden parachute payment” will be expanded to replicate the new definition under the CPP above. The institution will be denied a tax deduction, and the SEO will be subject to an excise tax for all golden parachutes as that term is defined for this purpose. This includes payments made following a termination of employment, whether or not in the context of a change-in-control.
- 2) Deduction Limitations Under Section 162(m): Same as the CPP, above.
- 3) Prohibition on new “Golden Parachute” Agreements: Participating institutions cannot enter into *new* employment contracts with SEOs that provide for “golden parachute payments” (as defined above) during the entire TAAP period. For this purpose, “new” would include any contracts renewed or materially modified from the time the institution enters into the TAAP until the expiration of the TAAP period (either December 31, 2009 or, if extended, October 3, 2010). A material modification occurs when the contract is amended to increase the amount of compensation payable to the SEO or to accelerate the vesting or payment of incentives and other amounts.

PM&P Observation: This prohibition applies to written and oral agreements, as well as to arrangements under broad-based severance plans. As a result, the Compensation Committees of companies participating in the TAAP should be wary of instituting, renewing or materially modifying any broad-

based termination policies or agreements in which a SEO may participate. It is also possible that an increase in base salary could trigger a material modification if base salary is part of a severance formula, which is typically the case.

What are the executive compensation limitations under the SSFI?

While the Treasury is still developing this program (which will be negotiated on a case-by-case basis with institutions), guidance issued so far regarding SEO compensation includes:

- 1) Limits on Incentives Tied to Inappropriate or Excessive Risk: Same as the CPP, above.
- 2) “Clawback” Programs: Same as the CPP, above.
- 3) Prohibition on “Golden Parachute” Payouts Under Section 280G: Same as the CPP, but the restrictions are more stringent in defining “golden parachute payment” to include *any* payment to a SEO due to applicable severance from employment. In contrast, a golden parachute payment in the CPP and the TAAP programs is defined with reference to only the portion of the termination payment that equals or exceeds the “three times base amount” threshold.

PM&P Observation: Presumably, because institutions participating in the SSFI will be in worse financial condition than those in the CPP or the TAAP, the Treasury is prohibiting any termination payouts to SEOs, including what would otherwise be considered typical severance arrangements, rather than just “excessive” amounts. Such an outcome will leave executives who terminate employment or who are terminated by the institution, with no severance payments at all. In essence, the Treasury will override existing employment/severance agreements currently in place at a time when an institution may need to eliminate individual executives to help address its specific financial situation.

- 4) Deduction Limitations Under Section 162(m): Same as the CPP, above.

Do the rules apply to SEOs of subsidiaries, affiliates, etc. of companies participating in any of the three programs?

The executive compensation restrictions will apply to any other entity within the “controlled group” of the participating financial institution, as that term is used in the Code. However, the programs are limited to parent-subsidary relationships and not brother-sister relationships.

How do mergers, acquisitions and other corporate transactions impact who will be considered a SEO?

In general, if an unrelated company acquires an institution participating in one of the programs, the acquirer’s executives do not become subject to the compensation limitations. SEOs of the acquired target may not receive any golden parachute payments (as defined under the applicable program, above) until one year following the acquisition.

How long do the compensation limitations apply?

The CPP and the SSFI restrictions will be in effect as long as the Treasury holds a debt or equity position in the financial institution. The restrictions in place for financial institutions that participate in the TAAP apply until December 31, 2009 (or, if the EESA is extended, to October 3, 2010) regardless of whether the Treasury continues to hold an equity or debt position.

Conclusions

The new Treasury restrictions will increase the cost of management at participating companies, where more compensation will be rendered nondeductible for tax purposes. Compensation Committees will see their workload increase due to new compliance responsibilities, with the new restrictions also likely to significantly boost the importance of Compensation Committees, or those serving in a similar capacity, in the private sector.

While the restrictions apply only to companies that are receiving federal assistance, Compensation Committees of all companies should proactively be studying whether their own plans and programs promote any of the ills targeted by the EESA. For non-participating companies, the new restrictions potentially provide a preview of future legislative action, particularly under a new Administration and Congress after the November elections. In particular, Compensation Committees should consider:

- 1) Implementing reasonable clawbacks covering senior executives;
- 2) Analyzing the potential unintended consequences of highly leveraged incentive plans;
- 3) Reporting in the CD&A the Committee's analysis of how incentives correspond with risks; and
- 4) Reviewing severance agreements for reasonableness.

The SEC has already indicated that they will conduct a focused review of the proxy disclosures of the CPP participants. In addition, they suggested that it would be prudent for those companies not participating in the CPP to also be analyzing how their incentives correspond to risk, and if such assessment is done, to disclose it in the CD&A.

Finally, these rules could have a chilling effect on incentive compensation as companies rein in programs out of concern they may be perceived as promoting undue risk. If so, the Treasury may end up inadvertently undermining some of the progress toward pay-for-performance that has long been sought by governance and shareholder advocates and has served as the motive for other regulatory initiatives.

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