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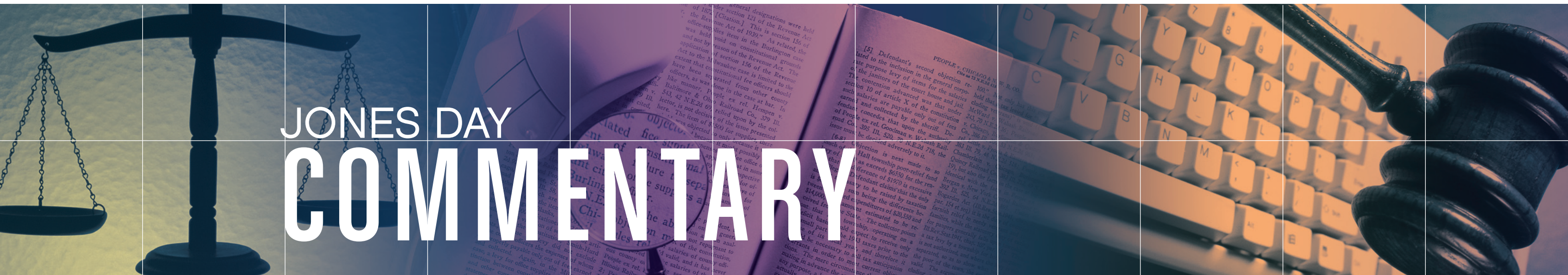

PUTTING THE BRAKES ON EXECUTIVE PAY: EXECUTIVE COMPENSATION LIMITATIONS FOR FINANCIAL INSTITUTIONS PARTICIPATING IN THE TROUBLED ASSETS RELIEF PROGRAM UNDER THE EMERGENCY ECONOMIC STABILIZATION ACT OF 2008

The Emergency Economic Stabilization Act of 2008 ("EESA") is the latest federal intervention in a continuing financial system crisis. EESA is designed to help stabilize credit markets by authorizing the Secretary of the Treasury ("Secretary") to acquire up to $700 billion of mortgage-related assets from financial institutions under the Troubled Assets Relief Program ("TARP"). The political compromises exacted in order to pass the legislation include further extensions of federal regulation of executive compensation, the precise scope of which is not apparent and may not be known for many months.

COMPENSATION PROVISIONS IN EESA

EESA includes direct federal restrictions and limitations, as well as new tax penalties, that will apply to executive compensation provided by financial institutions participating in TARP (collectively, the "Compensation Provisions"). The applicable Compensation Provisions will depend on the value of the troubled assets a financial institution sells and how the sales are implemented. The Compensation Provisions apply to private as well as public companies and appear to include almost no transition relief for existing compensation arrangements.

Direct Purchases. Where the Secretary acquires assets through direct purchases and receives a meaningful equity or debt position in the financial institution as a result of the transaction, the financial institution must meet standards for executive compensation prescribed by the Secretary that remain in effect as long as the Secretary holds the equity or debt position. EESA provides that these standards must include:

- Limits on compensation that exclude incentives for senior executive officers to take unnecessary and

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excessive risks that threaten the value of the financial institution during the period that the Secretary holds the equity or debt position;

- A "claw-back" provision for the recovery 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; and

- A prohibition on the financial institution making any golden parachute payment to its senior executive officer during the period that the Secretary holds the equity or debt position.

For this purpose, a "senior executive officer" means an individual who is one of the top five highly paid executives of a public company whose compensation is required to be disclosed pursuant to the Securities Exchange Act of 1934 (and its applicable regulations) (the "1934 Act"), and nonpublic company counterparts.

Auction Purchases. Financial institutions that participate in TARP auctions and either sell an aggregate of more than $300 million in troubled assets through auction, or receive combined assistance from direct purchases and auctions of more than $300 million, will be subject to the following executive compensation rules during the period that TARP is in effect. This period initially runs until December 31, 2009, but may be extended until October 3, 2010.

- A prohibition on entering into a new employment contract with a senior executive officer that provides a golden parachute in the event of an involuntary termination, bankruptcy filing, insolvency, or receivership.

- A $500,000 limitation under Section 162(m) of the Internal Revenue Code on the annual deduction of certain executive pay for a covered executive. The performance-based and commission-based compensation exceptions of Section 162(m) do not apply for this purpose. The limitation cannot be avoided by typical compensation deferral techniques.

- Application of the Internal Revenue Code golden parachute tax rules (the Section 280G deduction disallowance and Section 4999 20 percent excise tax) to payments received by a covered executive of a participating financial institution by reason of an involuntary termination, or in connection with any bankruptcy, liquidation, or receivership of the employer, even in the absence of a change in control. The reasonable compensation and private company exceptions under Section 280G that apply in a change in control setting will not apply here.

For this purpose, a "covered executive" means a financial institution's chief executive officer, chief financial officer, and the three highest compensated officers of the financial institution (not counting the chief executive officer or chief financial officer) determined on the basis of the 1934 Act shareholder disclosure rules for compensation, without regard to whether those rules apply to the employer.

IMPLICATIONS FOR FINANCIAL INSTITUTIONS

Participation in TARP will likely cause the Compensation Provisions to affect a financial institution and its executives and add complexity to an institution's decisions regarding participation in TARP.

Which of the Compensation Provisions Will Apply? The Secretary will make purchases of troubled assets in either direct purchases or through an auction process (or both). It is not clear how that decision will be made. The more onerous of the Compensation Provisions (prohibition on improper incentives, claw-back requirements, and prohibition on golden parachute payments) will apply, however, to institutions that participate in one or more direct purchases.

What Do Some of the Compensation Provisions Mean? Many of the Compensation Provisions are unclear. Are the compensation standards intended to cause financial institutions to abrogate or renegotiate existing compensation arrangements? If so, how is a financial institution expected to comply with the standards? Similarly, the new tax rules are effective immediately, without the traditional transition relief for existing agreements and plans. Moreover, many plans and agreements include provisions that contemplate the potential application of Section 162(m) or Section 280G of the Internal Revenue Code, which may produce effects that were not foreseen by Congress or anticipated by financial institutions.

How do the compensation standards apply, if at all, to the parent or holding company of a financial institution? Must claw-backs apply without regard to whether there was any misconduct or whether there was any connection between the senior executive officer and the financial statements? What constitutes an incentive to take unnecessary and excessive risks that threaten the value of the financial institution? What is the meaning of "golden parachute," "new employment contract," and "involuntary termination"?

We anticipate that some guidance will be forthcoming, although the timeframe is not clear.

How Would the Compensation Provisions Affect Management? The financial institution needs to assess how the Compensation Provisions may affect its officers whose compensation programs, contract rights, and tax situations could be altered. A review of existing compensation arrangements would be advisable. The threshold question is whether the financial institution's decision about participating in TARP could be affected by the possibility that the financial institution's top managers might leave rather than accept the effects of the Compensation Provisions. If the financial institution determines to move ahead with TARP, it needs to consider how it will communicate the effects of the Compensation Provisions to the officers and deal with their reactions.

What Steps Are Required To Be Eligible for TARP? It would appear that a financial institution's executive compensation programs and agreements would need to be consistent with the applicable Compensation Provisions in order for the financial institution to sell troubled assets under TARP. The review of the applicable programs described above should include planning for adopting the needed changes. Process issues (*e.g.*, compensation committee meetings and approvals) need to be considered, and documentary changes need to be prepared and implemented.

WHAT NEXT?

EESA represents an extraordinary exercise of federal authority to directly regulate decisions about how to compensate employees. Prior federal actions generally have affected the tax cost of certain compensation practices (*e.g.*, Sections 162(m), 280G, and 409A of the Internal Revenue Code), or how public companies must disclose their compensation programs to their shareholders. Basic decisions about how and how much to pay employees have largely been left to employers and their boards of directors, guided by state law standards. Early versions of EESA contained controversial shareholder access and say-on-pay provisions, which were eventually dropped. When viewed in the context of more general concerns about the amount and appropriateness of executive pay, the compensation measures adopted in EESA could foreshadow further federal efforts to directly regulate executive compensation.

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